

BANKRUPTCY

“WHAT EVERY CITY ATTORNEY SHOULD KNOW”

⇒ or ⇐

“ALL YOU CAN LEARN IN ABOUT 30 MINUTES (IF YOU STAY AWAKE & DON’T BLINK)”

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PURPOSES OF BANKRUPTCY

- Fresh Start -- discharge
- Save jobs- reorganization
- Similarly situated creditors treated similarly (prevent rush to court house)

WHERE TO FIND THE LAW:

- Congress shall have the power "to establish . . . uniform laws on the subject of bankruptcies throughout the United States." U.S. Const. art. 1, section 8.
- Title 11 U.S.C. (most of the Bankruptcy Code is codified here);
- Title 28 U.S.C. provisions on bankruptcy district court jurisdiction, some procedure, appeals, venue, removal from state court, bankruptcy judges, U.S. trustees, ADR, court personnel, filing fees, trustees' obligations
- 18 U.S.C. §§ 151-157, 1519, 3057, 3284 Bankruptcy Crimes & criminal investigations;
- 26 U.S.C. (U.S. Internal Revenue Code) 108, 1017, 1398, 1399, 6012, 6013, 6062, 6321-23, other §§
- FED. R. BANKR. P. & Local Bankruptcy Court Rules
- FED. R. CIV. P & Local District Court Rules, also FED. R. APP. P.
- Standing Orders & Local Local Rules – Court Web Sites.
- *!!!* State court decisions (*e.g.*, scope of discharge, applicability of automatic stay, res judicata of plan of reorganization; subject matter jurisdiction).
- Federal District Courts, Bankruptcy Appellate Panels, Courts of Appeal, and U.S. Supreme Court.
 - Bankruptcy Court Opinions/Memoranda: West (official) Bankruptcy Reporter ("B.R."), Collier Bankruptcy Cases, WL & Lexis, reported
 - District Court & BAP appeals are in F. Supp.;

- Circuit Court: F.3d & F.App.,
 - Finally U.S., L.Ed. S. Ct.
 - Collier (Matthew-Bender) & Norton (West) bankruptcy treatises;
 - American Bankruptcy Institute (ABI) – publications & www.abiworld.org.
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Figure 1: The Typical Situation on the Eve of Bankruptcy

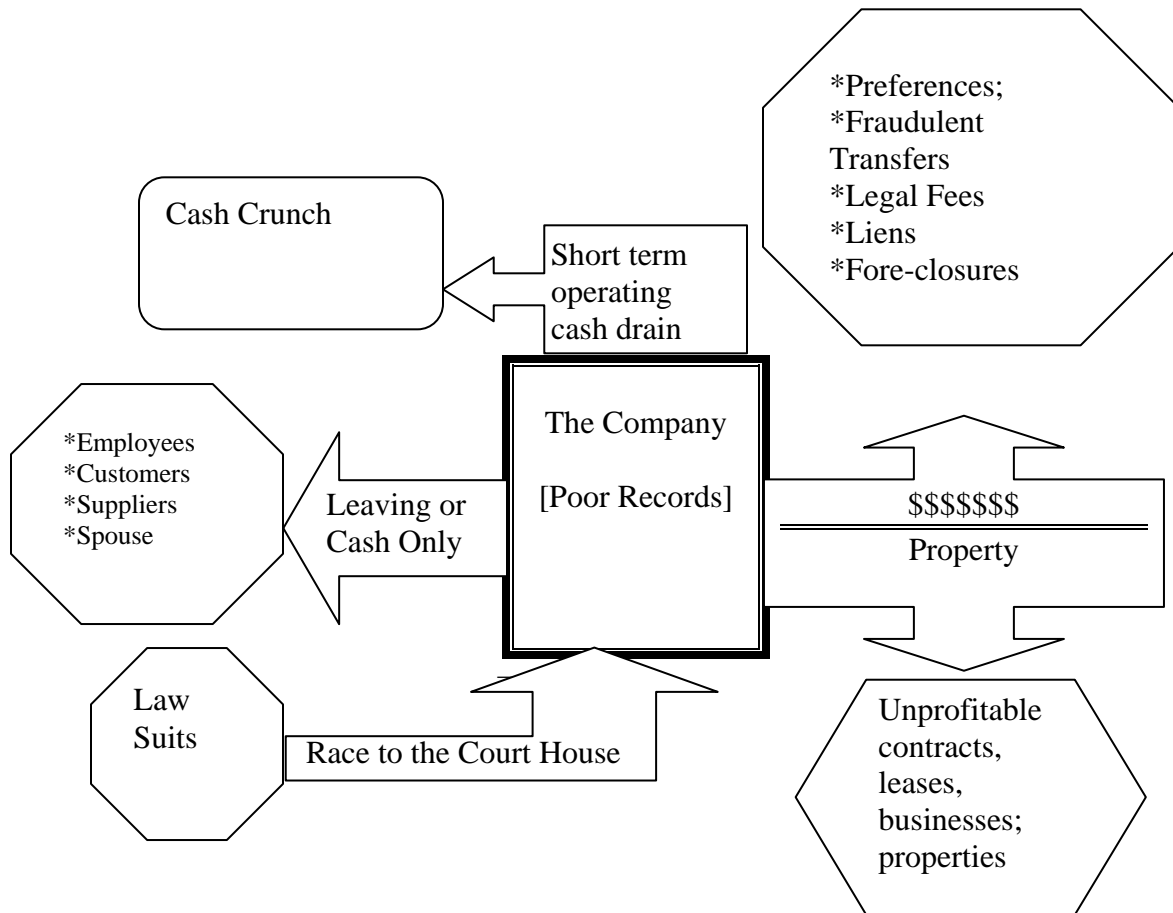


Figure 2: How Bankruptcy Tries to Address Problems

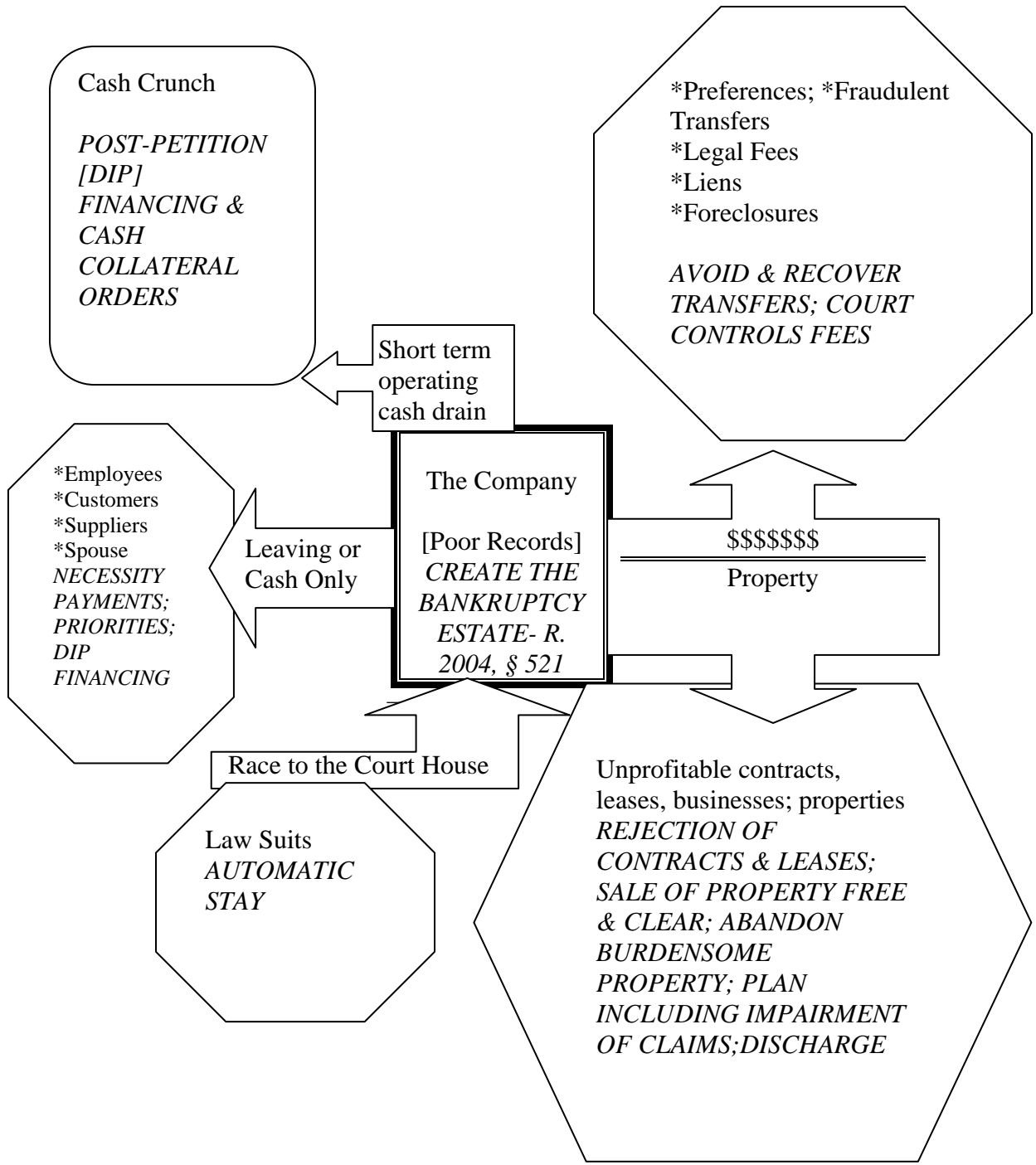


TABLE 1: COMMENCEMENT OF THE BANKRUPTCY CASE (alternative visualization for Figure 2 information)

PROBLEM	BANKRUPTCY “FREEZE”	DISCUSSION
Fleeing Suppliers	Doctrine of Necessity & Reassurance from DIP Financing § 364, Cash Collateral Orders & Sales Free & Clear § 363, & Bankruptcy Controls, §§ 503, 521, etc.	Really “key” suppliers’ claims MIGHT get paid – even if claims not – new financing and hemorrhage cessation provides reassurance
Fleeing Key Employees	Priority for small amount of prepetition wages & pension contributions § 507(a)(3) & (4) Doctrine of Necessity payments; Reassurance	Morale rather than immediate \$. On limited scope of doctrine of necessity, trend is to limit ability to pay “critical” vendors & employees. <i>See In re CoServ, L.L.C.</i> , 273 B.R. 487 (Bankr. N.D. Tex. 2002).
Fleeing Spouse	Child support not dischargeable § 523.	Oh Well
Law Suits	Automatic Stay § 362	Exception for Police & Regulatory Powers (<u>up to attempts to collect \$ Judgment!!!</u>)
Voluntary & Involuntary Transfers of Money & Property	Automatic Stay – includes liens & payments benefiting insiders § 362 Bankruptcy Code § 549 – Unauthorized post petition transfers Avoidance of preferences (§ 547) and fraudulent transfers (§ 548), § 550 (recovery)	Bankruptcy treats voluntary & involuntary transfers similarly – stay & avoidance 90 day reach-back for preferences extended to one year if preferential transfer benefits insider; Trustee also can use state law claims of any actual creditor.

PROBLEM	BANKRUPTCY “FREEZE”	DISCUSSION
“Poor Records”	*Estate & Fiduciary Duties Created; *Creditors’ Committee & *Trustee & U.S. trustee & Court supervision Turnover Actions – Includes Records §§ 542, 543	Strict court supervision & broad investigative powers of creditors, trustee, U.S. trustee, examiner.
Losing Contracts & Leases	Assumption or Rejection	Cannot assume or assign without Prompt Cure & Adequate Assurance of future performance
Losing Properties	Rejection; Abandonment; Sale free & clear	Environmental Liabilities cannot be abandoned
Cash Starved	DIP Financing, sale free & clear, cash collateral use	Super Priority Liens Adequate Protection

THE BANKRUPTCY CASE

1. Creates an “estate”
 - a. Fiduciary
 - b. Turnover
 - c. Jurisdiction in rem
 - d. Claims
 - e. Automatic Stay
2. District Court (Art. III) & Bankruptcy Court (Unit of District Court – Art. I) –
 - a. Core v. Non-Core v. No Subject Matter Jurisdiction 28 U.S.C. § 157(b)(2)¹

¹ 28 U.S.C. Sec. 157. - Procedures

(a) Each district court may provide that any or all cases under title 11 and any or all proceedings arising under title 11 or arising in or related to a case under title 11 shall be referred to the bankruptcy judges for the district.

(b) (1) Bankruptcy judges may hear and determine all cases under title 11 and all core proceedings arising under title 11, or arising in a case under title 11, referred under subsection (a) of this section, and may enter appropriate orders and judgments, subject to review under section 158 of this title. (2) Core proceedings include, but are not limited to - (A) matters concerning the administration of the estate; (B) allowance or disallowance of claims against the estate or exemptions from property of the estate, and estimation of claims or interests for the purposes of confirming a plan

- b. Interplay Due Process/28 U.S.C./Article III
 - c. Automatic Reference § 157(a)/Withdrawal of reference; Bankruptcy Judges ± Pro Debtor
3. Main Case Title 28 U.S.C., FED. R. BANKR. P. /Local District & Bankr. Court Rules
- a. Adversary Proceedings = Law Suits; Incorporate most FED. R. CIV. P.
 - b. Contested Matters – Summary motion practice- FED. R. BANKR. P. chapter 9.
 - c. Confirmation/discharge
 - i. Disclosure Statement
 - ii. Confirmation
 - iii. Cram Down –
 - 1. impaired claims
 - 2. Best Interests Test (absolute priority rule);
 - 3. Feasibility
 - 4. Fair & Equitable
 - d. The Bankruptcy Code chapters
 - i. 7-Liquidation – maybe will be precluded for individuals able to reorganize
 - ii. 9-Municipalities
 - iii. 11-Business Reorganization
 - iv. 12-Small Farmers with regular income – eliminated 1/1/2004 except for pending cases
 - v. 13-Wage Earners – maybe doomed
4. Players: + Attorneys/Experts/Consultants for each
- a. DIP (no trustee, usually chapter 11) v. Debtor (trustee, ch. 7, 13). DIP has all powers, rights, & duties of trustee except right to compensation.

under chapter 11, 12, or 13 of title 11 but not the liquidation or estimation of contingent or unliquidated personal injury tort or wrongful death claims against the estate for purposes of distribution in a case under title 11; (C) counterclaims by the estate against persons filing claims against the estate; (D) orders in respect to obtaining credit; (E) orders to turn over property of the estate; (F) proceedings to determine, avoid, or recover preferences; (G) motions to terminate, annul, or modify the automatic stay; (H) proceedings to determine, avoid, or recover fraudulent conveyances; (I) determinations as to the dischargeability of particular debts; (J) objections to discharges; (K) determinations of the validity, extent, or priority of liens; (L) confirmations of plans; (M) orders approving the use or lease of property, including the use of cash collateral; (N) orders approving the sale of property other than property resulting from claims brought by the estate against persons who have not filed claims against the estate; and (O) other proceedings affecting the liquidation of the assets of the estate or the adjustment of the debtor-creditor or the equity security holder relationship, except personal injury tort or wrongful death claims.

* * *

- b. U.S. trustee – DOJ Officials assist Bankr. Judge & Monitor Debtor (distinguished from private individuals appointed as “trustee” in specific cases or standing chapter 13 trustee. Ch. 7 & 11 trustees usually appointed from a prequalified panel.
 - c. Creditors’ Committee(s) – Official v. Unofficial
 - d. Trustee, Examiner
 - e. Regulators – SEC, FEMA, FERC, RRC, TDI, FCC
 - f. State Attorney General on behalf of consumers – FED. R. BANKR. P. 1109(b) – appear & argue but not litigate or appeal
 - g. Municipal regulators!?! (zoning; urban blight, SOB, franchisee – FED. R. BANKR. P. 1109 standing to appear & be heard even if not creditor.
 - h. Taxing Authorities – IRS, Comptroller, Cities
5. City’s potential roles in bankruptcy case (in addition to ch. 9 debtor):
- a. Unsecured general creditor;
 - b. Unsecured priority creditor (taxes);
 - c. Secured creditor;
 - d. Franchising or licensing authority (gas, telecommunications, cable TV);
 - e. Water, gas, electric utility provider;
 - f. Regulator (zoning, SOBs, urban rehabilitation, towing, parking, aviation, billboard signs, landfills);
 - g. Co-debtor or guarantor (economic development);
 - h. Criminal prosecutor (traffic, City Code)
 - i. Employer;
 - j. Fiduciary (employee retirement plan);
 - k. Attorney (special counsel -- defending debtor employee indemnity))

NEAT BANKRUPTCY STUFF TO KNOW

1. In a voluntary case – the “order for relief” IS the filed bankruptcy petition. “Prepetition” means prior to filing of the voluntary petition. Filing the petition (“entry of the order of relief”) triggers the automatic stay, fiduciary duties, turnover obligations, limitations periods running, and a host of other provisions. In an involuntary case, the order for relief is entered with the involuntary petition is accepted for filing after notice & hearing.
2. Ordinarily, Governmental Units cannot serve on chapter 11 official committee of unsecured creditors – not “persons” 28 U.S.C. § 1102(b)(1) (“persons willing to serve”) - - tough to get judge to form committee of cities or gov’t units, but permissible. 28 U.S.C.

§ 1102(a)(2) – authority to appoint additional committees – but drain on estate because attorneys, advisers, and members entitled to reimbursement/compensation from estate.

3. Debtor obligated to comply with all local laws & can be sued if fails to do so: 28 U.S.C. § 959(a).
4. Police & regulatory powers exception to automatic stay extends to everything BUT enforcement of money judgment, but only as to § 262(a)(1) [suit or administrative proceeding that could have been started prepetition], (2) enforcement of prepetition judgment; (3) obtaining or controlling property of estate, & (6) collection of prepetition claims. Bankruptcy Code § 362(c)(4).
 - a. When is proceeding regulatory (within (c)(4) exception) v. compensatory (subject to the automatic stay)? *E.g.*, Per diem penalties & injunctive relief (police powers) v. reimbursement for investigative & enforcement expenses (compensatory).
 - b. Bankruptcy Code § 105(a) (“all writs” injunctive powers of bankruptcy court) – narrowly construed. Not roving commission.²
 - c. But still there & often invoked by debtors.
5. City as public utility 11 U.S.C. § 366 – once adequate protection approved by court furnished, utility needs court approval to increase deposit or terminate service. But if no § 366 order within 20 days – utility may terminate (§ 366 says “adequate assurance” must be furnished – usually means court-approval. If in doubt – get court order permitting termination).

² “Section 105 provides that a bankruptcy court “may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Bankruptcy Code].” 11 U.S.C. § 105(a). Although we interpret § 105 liberally, *Momentum Mfg. Corp. v. Employee Creditors Committee (In re Momentum Mfg. Corp.)*, 25 F.3d 1132, 1136 (2d Cir.1994), a § 105 injunction must be consistent with the rest of the Bankruptcy Code, *see Chiasson v. J. Louis Matherne & Assocs. (In re Oxford Mgmt., Inc.)*, 4 F.3d 1329, 1334 (5th Cir.1993) (“[T]he powers granted by that statute must be exercised in a manner that is consistent with the Bankruptcy Code.”). A § 105 injunction cannot alter another provision of the code. *Id.* (holding that § 105 injunction was improper because it purported to alter other Code provision). [FN42]

“FN42. *See also Landsing Diversified Props. v. First Nat'l Bank & Trust Co. (In re Western Real Estate Fund, Inc.)*, 922 F.2d 592, 601 (10th Cir.1990) (“[A] bankruptcy court's supplementary equitable powers [under § 105(a)] may not be exercised in a manner that is inconsistent with the other, more specific provisions of the Code.”); *Southern Ry. Co. v. Johnson Bronze Co.*, 758 F.2d 137, 141 (3d Cir.1985) (“[S]ection 105 does not authorize the bankruptcy court to create rights not otherwise available under applicable law.”); *cf. United States v. Sutton*, 786 F.2d 1305, 1308 (5th Cir.1986) (holding that § 105 “does not authorize the bankruptcy courts to create substantive rights that are otherwise unavailable under applicable law, or constitute a roving commission to do equity”).”

In re Zale Corp., 62 F.3d 746, 759-60 (5th Cir. 1995).

6. Reorganization Rights for Tax Claims:

a. 11 U.S.C. § 1129(d): “Notwithstanding any other provision of this section, on request of a party in interest that is a governmental unit, the court may not confirm a plan if the principal purpose of the plan is the avoidance of taxes . . . In any hearing under this subsection, the governmental unit has the burden of proof on the issue of avoidance.

b. UNLESS CREDITOR CONSENTS TO DIFFERENT TREATMENT:

i. Priority tax claims are described in Bankruptcy Code § 507(a)(8). Includes unsecured claims for taxes (due within stated periods pre-petition) measured by gross receipts, property taxes, & excise taxes, plus penalties associated with any of them. Note administrative claims (taxes coming due during the case) entitled to higher priority (§ 507(a)(1)).

ii. Priority tax claims must be paid under plan to extent of deferred cash payments, over a period not exceeding six years after assessment date, of a value, as of the effective date of the plan (expert testimony necessary), equaling the allowed amount of the claim. Bankruptcy Code § 1129(a)(9)(C).

iii. Interest continues to accrue as to any delayed payments of priority tax claims. Bankruptcy Code § 1129(a)(9)(C) – But market rate rather than statutory rate;

iv. Interest also due on any deferred payments in respect of secured claims.

7. Claim as tax v. lease or contract: Trade off of state v. bankruptcy advantages (illegal tax v. priority)

8. Texas Cities are eligible for chapter 9: (Bankruptcy Code § 109(c) requires specific state authorization for a municipality to be eligible for chapter 9 relief):

Local Government Code § 140.001. Relief Under Federal Bankruptcy Laws for Municipality, Taxing District, or Other Political Subdivision

(a) A municipality, taxing district, or other political subdivision that is subject to this section may proceed under all federal bankruptcy laws intended to relieve municipal indebtedness.

(b) A municipality is subject to this section if it has the power to incur indebtedness through the action of its governing body. A taxing district or other political subdivision is subject to this section if it has the power to incur indebtedness either

through the action of its governing body or through that of the county or municipality in which it is located.

(c) The officials and governing body of the municipality, taxing district, or other political subdivision may adopt all proceedings and take any action necessary or convenient to fully avail the entity of the federal bankruptcy laws.

9. Taxes paid on time can never be preferences. “In the tax context, [§ 547(c)(2)] will mean that a payment of taxes when they are due, either originally or under an extension, . . . will not constitute a voidable preference.” H.R. Rep. No. 595, 95th Cong., 1st Sess. 373 (1977); *accord, e.g., In re Valley Steel Prod. Co., Inc.*, 214 B.R. 202 (E.D. Mo. 1997); *see also* Bankruptcy Code § 547(c)(2) (payment in ordinary course preference defense), which provides that a trustee (debtor in possession) may not avoid a transfer under §547 to the extent that such transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and transferee, with payment made in the ordinary course of business or financial affairs of the debtor and transferee and made according to ordinary business terms. The payment of a tax on or about the deadline for payment and before the occurrence of penalty or interest qualifies as ordinary course payment.
10. Not filing a claim: Advantages v. Risks
11. E-Filing: Practical Problems – training & getting a credit card.
12. Rule 2004/ § 521 Examinations: Major discovery powers re debtors business, property, operations.
 - a. Q. Admissible in future proceedings as deposition or only as statement against interest/statement of a party?
 - b. Use answer as basis for questions in later litigation.
 - c. Also use schedules & statements of financial affairs as discovery source.
13. In Chapter 11 or 13 – DO NOT CONTINUE AUTOMATIC WITHDRAWAL FROM DEBTOR/EMPLOYEE’S SALARY TO REPAY 401(K)/IRA LOANS WITHOUT COURT ORDER!! This violates automatic stay prohibition against using property of estate, although debtor’s counsel will try to talk you into keeping loan payments current to avoid adverse tax consequences for debtor. In chapter 13, Court probably would not authorize payments because they do not qualify under Bankruptcy Code § 1305(b) – consumer debt “necessary”: for debtor’s performance under a chapter 13 plan.

14. “United States trustee” [sic] – the “t” is lower case. *See* 28 U.S.C. § 581. Have fun with it (e.g., references in court filings), BUT maintain good & continuing relations with local U.S. trustee’s office.
 - a. Critical when dealing with outlaw debtor to have cooperation of UST. Can serve as allied amicus & court will listen to UST.
 - b. Ideal situation: UST will alert City Attorney if suspicious activities by debtor within City’s sphere of concern.
15. Stay relief litigation: Bankruptcy Code § 362; FED. R. BANKR. P. 4001(a):
 - a. If in doubt as to whether stay applies – seek relief!!!
 - b. \$150.00 filing fee for motion for relief unless agreed relief (less than law suit but other bankruptcy motions have no filing fee).
 - c. “Declaration that stay not applicable” -- requires full-blown adversary proceeding (law suit) including 30 days to answer – if time is important – don’t use. TRO won’t allow altering status quo.
 - d. Therefore – file motion for relief from the automatic stay to extent, if any, that the stay applicable. Can be decided on emergency basis.