<u>Bankruptcy: A Brief Primer</u>

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The COVID-19 pandemic and the related state government ordered shutdowns across the country have caused a disruption to the U.S. economy that is unprecedented in our time. This has resulted in many American businesses having (i) to deal with the ramifications of many of their counterparties seeking relief under federal bankruptcy law, and (ii) in many instances, to consider becoming a debtor in bankruptcy. The following is a brief introduction to some bankruptcy basics.

There Are Different Types of Bankruptcy Proceedings

The United States Bankruptcy Code provides several distinct options for business entities and individuals contemplating the filing of a voluntary petition seeking bankruptcy relief. These options are:

Chapter 7

Chapter 7 is a liquidation proceeding in which the ordinary course business operations of the debtor entity or individual cease and a Bankruptcy Court-appointed trustee administers and liquidates the debtor's assets for the benefit of creditors.

• The debtor must generally relinquish possession and control of its assets and books and records to the trustee, who succeeds to the debtor's rights, title and interests in those assets.

• The debtor must cooperate with the trustee's requests for information and the individual debtor, or a representative of the debtor if the debtor is an entity, must appear and answer questions at a "first meeting of creditors" (and potentially in additional sessions if ordered by the bankruptcy court).

• The debtor and insiders of the debtor (e.g., officers, directors, managers and owners and in some cases their close family members) may be subject to investigation with respect to their pre-petition conduct and the debtor's pre-petition affairs, and/or, in the case of insiders, their business dealings with the debtor. In some cases, the debtor and/or insiders of the debtor may be subject to lawsuits (referred to in bankruptcy as "adversary proceedings") in which the bankruptcy trustee seeks to recover money and/or other property for the benefit of the bankruptcy estate. Such adversary proceedings may allege fraudulent conveyances, preferential transfers, breaches of fiduciary duty and/or other theories of recovery pursuant to bankruptcy and/or applicable non-bankruptcy law.

Chapter 11

Chapter 11 cases can involve:

(i) a true reorganization, in which the debtor retains possession and management of its assets, continues to operate its business as a debtor-in-possession and ultimately solicits creditor acceptance of a plan of reorganization (essentially a court-approved contract between the debtor and its creditors for the repayment of debt) pursuant to which existing equity holders may retain ownership and control of the reorganized debtor if the debtor is able to confirm a plan and exit bankruptcy; or

(ii) the sale of substantially all of the debtor's operating assets pursuant to a Bankruptcy Court-approved sale process that typically involves the opportunity for competitive bidding by qualified bidders and an auction, and which is followed by either a plan for the liquidation of the debtor's remaining assets or a conversion of the case to Chapter 7.

• In most Chapter 11 cases, the Office of the United States Trustee forms a Creditors' Committee. The Creditors' Committee has standing to play an active role in the Chapter 11 case in representing the collective interests of unsecured creditors of the bankruptcy estate. This may involve the Committee seeking standing to bring and prosecute certain actions that the debtor may be unwilling or unable to pursue, including claims against insiders of the debtor and avoidance recovery actions. The Creditors' Committee may hire legal counsel and other professionals, paid for by the debtor's bankruptcy estate.

• If the debtor is unable to propose and confirm a plan within certain statutorily prescribed periods of time, there is the opportunity for other parties in interest to file and seek confirmation of their own competing plan.

• For "cause", the Bankruptcy Court may (a) usually in the case of fraud, misappropriation of funds or other misconduct by the debtor's management or owners, appoint a reorganization trustee to supplant the debtor in possession, or (b) convert the Chapter 11 case to a liquidation proceeding under Chapter 7.

Small Business Chapter 11

The Small Business Reorganization Act of 2019 (the "SBRA"), which became effective on February 19, 2020, provides streamlined relief under Chapter 11 for certain qualifying small businesses and individuals and is intended to strike a balance between Chapter 7 and Chapter 11. Relief pursuant to the SBRA is available to qualifying small business debtors whose debts do not exceed a certain dollar threshold. Pursuant to the Coronavirus Aid, Relief and Economic Security Act of 2020 (the "CARES Act"), as enacted in March 2020 by Congress, this maximum debt level was increased from $2,725,625 to $7,500,000. Highlights of the SBRA include:

• Subject to certain limited exceptions, the small business must file its Chapter 11 plan within 90 days of the date that it files its bankruptcy petition.

• A standing trustee is appointed to oversee the small business case.

• No Creditors' Committee is formed.

• The rights of certain secured creditors can be modified.

• Unlike a traditional Chapter 11 case, in a small business Chapter 11, the Bankruptcy Court can confirm a plan without the support of any class of claims if the plan does not discriminate unfairly and is determined to be fair and equitable with respect to each class of claims.

Chapter 13

Chapter 13 is available to certain qualifying individuals (i.e., not businesses) with regular income and permits them to utilize this form of bankruptcy as a cheaper and easier alternative to Chapter 11. Assuming that the debtor can provide creditors with a recovery at least equivalent to what they would receive in a Chapter 7 liquidation, Chapter 13 provides the opportunity for individual debtors to make payments over three to five years pursuant to a Bankruptcy Court approved "wage earner's" plan. Chapter 13 also provides the debtor with the opportunity to retain ownership and control of certain key assets (*e.g.*, a residence).

Automatic Stay

The filing of a case under the Bankruptcy Code triggers an "automatic stay." This means that upon the filing of a bankruptcy petition, creditors are statutorily prohibited from taking action against a debtor's assets. The stayed actions include, but are not limited to, collecting accounts receivable, enforcing pre-petition judgments against the debtor, perfecting or enforcing liens granted pre-petition, foreclosing on collateral, and terminating contracts or leases on account of pre-petition defaults. In addition, to the extent there is any pending litigation against a debtor, that litigation is also stayed.

A creditor or other party-in-interest may file a motion in the Bankruptcy Court to seek relief from the automatic stay in certain circumstances, but bankruptcy courts usually provide a debtor with an opportunity to pursue relief in the Bankruptcy Court before granting that relief.

Executory Contracts and Unexpired Leases

In a chapter 11 bankruptcy case, section 365 of the Bankruptcy Code provides that a debtor may "assume" or "reject" executory contracts or unexpired leases. In connection with a proposed assumption, and subject to certain requirements, a debtor may also assign its interest in the particular contract or lease to a third party. This right of assignment exists even if the contract or lease limits or prohibits assignment.

In order to assume a lease or an executory contract in bankruptcy, a debtor must file a motion and demonstrate that it will: (i) cure any defaults under the lease or contract; and (ii) provide adequate assurance of future performance to the lease or contract counterparty. The cure of any defaults includes, but is not limited to, the payment in full of all amounts that are due and owing under an unexpired lease or executory contract, including obligations that arose prior to and after a bankruptcy filing.

With respect to an unexpired lease of nonresidential real property, a debtor has 120 days from the date of the bankruptcy filing to decide whether to assume or reject a lease. This deadline can be extended by 90 days if a debtor can demonstrate good cause for such an extension, but it cannot be further extended without the landlord's consent. With respect to an executory contract, the debtor has until the confirmation of a bankruptcy plan to make an assumption or rejection decision, but a counterparty to such contract can ask the court to require the debtor to make a decision sooner.

During the time for a debtor to decide whether to assume or reject an unexpired lease, a debtor must pay all post-filing obligations that arise under the lease in the ordinary course of business.

Finally, as part of the decision on whether to assume or reject a lease, as a practical matter, a debtor can use the bankruptcy as an opportunity to renegotiate the terms of a lease going forward, as well as any past due liabilities, as conditions to assuming the lease. A landlord is not under any legal obligation to agree to any proposed modifications to an existing lease. However, depending on the terms of the lease and a landlord's specific situation, including market conditions, a landlord may or may not be willing to negotiate with respect to lease terms and/or cure amount.

In the event that a debtor chooses to reject an unexpired lease or executory contract, such lease or contract immediately terminates upon the entry of the rejection order by the court. The resulting damages claim, including pre-petition amounts due to the lease or contract counterparty, will primarily be general unsecured claims in the bankruptcy case. In the case of rejection damages resulting from leases of nonresidential real property, damages are subject to a statutory cap.

Notably, depending on the jurisdiction, courts may treat differently rent that is due between the date a bankruptcy case is filed and the end of that same month. Some courts require this "stub rent" to be paid for the month it was incurred pro rata, while other courts consider the entire obligation a prepetition debt that need not be paid as standard post-petition rent.

Unless otherwise provided pursuant to approved procedures in a particular case, a creditor must first obtain an order of the Bankruptcy Court permitting the creditor to setoff a security deposit against the debtor's outstanding and unpaid obligations under the lease or contract.

Preferences

If a debtor files for bankruptcy, payments made by the debtor to creditors prior to the bankruptcy filing may be avoided and recovered by a debtor or a bankruptcy trustee. The policy behind this is to prevent debtors from favoring certain creditors prior to a bankruptcy filing, and to discourage aggressive collection actions that could force a debtor to file for bankruptcy.

A payment or transfer made to a creditor prior to a bankruptcy filing is subject to avoidance and recovery as a preferential transfer if:

- The payment was made to or for the benefit of the creditor;
- The payment was made for or on account of a prior debt owed by the debtor before the transfer was made;
- The payment was made while the debtor was insolvent;
- The payment was made within 90 days before the filing of the bankruptcy case (or one year before the filing of the bankruptcy case if the payment was made to an insider of the debtor); and

- The payment enabled the creditor to receive more than it would have received if the case was a chapter 7 liquidation.

If a debtor or trustee seeks to avoid a payment as a preferential transfer, the Bankruptcy Code provides certain defenses to creditors. These include: (i) that the payment was made in the ordinary course of business; (ii) the payment was made as a contemporaneous exchange for value; and (iii) the creditor provided new value to the debtor subsequent to the allegedly preferential payment.

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