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A Creditor's Thumbnail Guide to Bankruptcy

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If you provide goods, services, credit or money to others and expect (or hope) to be paid for what you provide, then you are a "creditor." Your right to payment is your "claim."[1] In order to better manage risks, creditors should be especially careful when dealing with those who are (or may become) insolvent, i.e. with liabilities exceeding assets or generally not able to pay debts as they fall due.[2] Federal bankruptcy law often intervenes in such relationships by, among other things: imposing an automatic stay, requiring certain payments already made to creditors be returned, avoiding or reducing liens, re-writing contracts and discharging debtors from future personal obligations. Like competitors at any good sporting event, creditors must be prepared—on offense and defense—to improve their position in bankruptcy.

I. Creditor Offense

Creditors typically choose whether, and how aggressively, to enforce claims against: (1) the debtor's bankruptcy estate, (2) the debtor, (3) co-borrowers or guarantors and (4) any collateral. Some options, however, are lost if not pursued quickly. Fear of violating the automatic stay, which could result in punishment, often results in an inability to move and uninformed creditors pay a price.

The automatic stay is a very broad and powerful injunction, stopping any and all actions a creditor might want to take against a debtor and her assets. The stay is imposed immediately when the bankruptcy case is filed. The automatic stay is intended to protect the debtor—and all other creditors—from an overreaching creditor who grabs first. For example, without the automatic stay, a creditor holding a $100,000 first trust deed in a $1 million asset could foreclose on that asset and deprive the debtor and other creditors from $900,000 in equity.

Actions taken in violation of the automatic stay are void in California and the Ninth Circuit.[3] Those who violate the stay willfully can be sanctioned with damages, costs, attorneys' fees and under certain circumstances, even punitive damages.[4] There are numerous exceptions to the automatic stay, however and the automatic stay eventually terminates by operation of law. Creditors can get relief from the automatic stay to go about their business, especially when the bankruptcy estate is not harmed in the process. An informed approach can help creditors stay on offense and get paid promptly.

1. Claims against the Estate

When a debtor files for bankruptcy protection, virtually all the debtor's interests and assets become property of the bankruptcy estate.[5] Creditors must generally file a proof of claim, with supporting documents, to get paid.[6] Not all claims are treated equally, however. Claims are paid based on their status—secured, priority or unsecured—where a lower status claim is typically paid only if and when all claims of higher priority are paid in full.[7] Claims supported by both (1) a valid security interest and (2) value in property are paid first to the extent of the value of the property.[8] Claims preserving the estate or benefiting all creditors (e.g., for goods provided to a debtor shortly before or during bankruptcy) receive priority status and get paid before other unsecured claims.[9] Moreover, claims against the estate arising *after* bankruptcy (including rent) are often given priority status and a debtor in possession or trustee who decides to assume or assign certain contracts or leases in default must typically cure all defaults, compensate for various losses caused by default (e.g., attorneys' fees) and provide adequate assurance of future performance to hedge against future defaults.[10]

When there is not enough to pay an entire class of claims, creditors in that class share *pro rata*. As a result, timely filing a claim may be the difference between sharing with other creditors and getting nothing. A creditor does not need relief from stay to file a proof of claim or bring a motion against the estate.

2. Claims against the Debtor

The main goal for an individual debtor in bankruptcy is to get a discharge from future personal liability in exchange for giving up all non-exempt property. A discharge relieves the debtor from any obligation to make payment on her debts. Creditors have a couple tools to prevent a debtor from getting a discharge. If a debtor is less than completely forthcoming when preparing her bankruptcy schedules—hoping to conceal assets from creditors—creditors can sue the debtor in bankruptcy to deny her entire discharge, which benefits all creditors.[11] In addition, certain claims automatically survive bankruptcy, such as domestic support obligations, and others can be made non-dischargeable when based upon the debtor's fraud, embezzlement or other bad acts that happened before bankruptcy.[12]

As with filing a proof of claim, there are strict deadlines for bringing an action against a debtor, and the automatic stay does not prevent creditors from bringing these actions in the bankruptcy court. On the other hand, if the creditor does not file its action against a debtor on time, the creditor will be prohibited from pursuing those claims against the debtor. There is not much a creditor can do about an honest debtor's "fresh start." But informed and prepared creditors have a number of options to stop abusive bankruptcies, keep debtors from "gaming the system," and prevent an undeserved windfall.

3. Claims against Third-Parties

Creditors often look to co-borrowers or guarantors to help satisfy their claims. With limited exceptions, the automatic stay protects

only a debtor in bankruptcy and her property.[13] In many instances, an informed creditor can dismiss a debtor in bankruptcy from a lawsuit and continue claims against third-parties. Moreover, a debtor's discharge does not help co-borrowers or guarantors. Creditors that pressure co-borrowers and guarantors often get paid much sooner than others.

4. Claims against Collateral

A creditor with a valid security interest in property can often foreclose on that property, which serves as collateral, and get paid from the proceeds. In most instances, creditors must obtain relief from the automatic stay by showing the bankruptcy court the property both (1) has no equity for the estate and (2) is not necessary for an effective and timely reorganization.[14] In some instances, the stay will automatically terminate upon certain events.[15] If the creditor is not completely paid from the collateral, then it can often pursue the other three options discussed above.

II. Creditor Defense

Taking a bankruptcy notice to mean that nothing further can be done can be a serious mistake. In fact, creditors should be vigilant in the bankruptcy case to watch out for motions or lawsuits that adversely affect their claims or security interests.

Many chapter 11 or 13 debtors use bankruptcy to avoid or strip junior liens against their residence where such liens are not supported by any value. Very often these motions are supported by the debtor's (grossly understated) declaration and are decided very quickly. The vigilant creditor who timely objects and proves even $1 in value above senior secured debt may entirely preserve its junior lien.[16] Ignoring these motions often results in lost security interests and claims being converted from secured to unsecured.

A major policy consideration in bankruptcy is equitable distribution of assets. Along these lines, trustees or "debtors in possession" can sue creditors to recover potentially preferential payments. For example, if a debtor completely pays off friends and family just before bankruptcy while giving arms-length creditors nothing but a cold shoulder, a trustee can sue those friends/family to recover the money they received, even on legitimate debts, and then redistribute those funds (less fees, of course) to pay every creditor their *pro rata* share. Preference actions are great in theory, but often dismal in practice. Some trustees or debtors in possession sue everyone who received more than $5,850 in the aggregate within 90 days of bankruptcy, while the debtor is presumed insolvent.[17] There are numerous defenses that can completely insulate a creditor from any liability—payments made in the ordinary course of business for example—and many cases can be settled for a small fraction of alleged preference payments.[18]

Finally, chapter 11 or 13 debtors typically file plans of reorganization to alter various contract or state law rights. Creditors should immediately seek bankruptcy counsel to make sure their rights are adequately protected. Defending against a reorganization plan can be difficult and nuanced. Failure to do so, however, may be extremely costly.

Summary

In sum, creditors in bankruptcy can (and should) be equipped to safely pursue claims and avoid pitfalls. With the volume of bankruptcy cases pending (and looming), creditors must know how to maneuver on both offense and defense. Uninformed creditors who do neither may ultimately face their own insolvency concerns as they walk away from or hand over needed working capital.

1 Title 11 of the United States Code – The Bankruptcy Code – specifically defines "creditor" and "claim" at section 101(10) and (5), respectively.
2 Section 101(32) specifically defines "insolvent."
3 *See, e.g., In re Schwartz*, 954 F.2d 569 (9th Cir. 1992).
4 Section 362(k).
5 Section 541 defines property of the estate and includes essentially all legal or beneficial interests at the commencement of bankruptcy.
6 Sections 501 and 502 deal with filing claims.
7 Section 726.
8 Section 506. The valid security interest must be recorded/perfected and typically more than 90 days before the debtor's bankruptcy case was filed. See section 547 and 550.
9 Section 507(a). Super-priority or super-secured status is even given where a creditor extends money or credit in bankruptcy for a debtor to reorganize (often referred to as debtor-in-possession or DIP financing). See sections 364 and 507(b).
10 Sections 365(b)(1) and 503. Section 1326(a) requires a chapter 13 debtor to begin making scheduled lease payments to a lessor of personal property within 30 days after the petition if the debtor intends to assume the lease.
11 Section 727.
12 Section 523.
13 Section 1301 stays actions against co-borrowers for certain consumer debts.
14 Section 362(d)(2). In chapter 7 cases there is no reorganization so creditors can get relief just by showing no equity.
15 Section 362(c) and (h).
16 *Lam v. Investors Thrift (In re Lam)*, 211 B.R. 36, 40-41 (9th Cir. BAP 1997) and *Zimmer v. PSB Lending Corp. (In re Zimmer)*, 313 F.3d 1220, 1227 (9th Cir. 2002).
17 Section 547(b) and (c)(9).
18 Section 547(c).

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