Best Practices
Non-Individual/Business

State Debts and Liquor Permits

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BUSINESS CHAPTER 7 BEST PRACTICES

STATE DEBTS AND LIQUOR PERMITS

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NORTHERN DISTRICT OF OHIO
BENCH BAR RETREAT

October 30, 2015

I. OVERVIEW

A. State of Ohio is represented by the Ohio Attorney General's Office ("AGO").

B. Debt delinquent more than 45 days is certified to the AGO for collection - O.R.C. § 131.02.

C. AGO Collections Enforcement Section is section within AGO responsible for collection of State debt.

D. The AGO collects debt for more than 200 State Departments, Boards, Commissions, Universities and Agencies.

E. Certain Assistant Attorneys General within Collections Enforcement are tasked with representing the State of Ohio in U.S. Bankruptcy Courts in Ohio and nationwide.

F. Our Bankruptcy Group includes 8 Assistant Attorneys General located in:

Columbus

Cleveland

Cincinnati

Toledo

Youngstown

H. The AGO contracts with private attorneys who are appointed Special Counsel to represent the state in bankruptcy and collections cases.

Collections Enforcement Bankruptcy AAG'S Contact List

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Handles Cincinnati & Dayton Bankruptcy Courts

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Columbus, Ohio 43215
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Main Fax: 614-752-9070

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Handles Columbus Bankruptcy Court

Donn Rosenblum

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Handles Akron Bankruptcy Court

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Main Fax: 216-787-3480

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Email: alison.archer@ohioattorneygeneral.gov

Handles Cleveland Bankruptcy

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Email: trish.lazich@ohioattorneygeneral.gov

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One Government Center, Suite 1240

Toledo, Ohio 43604
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Main Fax: 419-245-2520
Email: robert.doty@ohioattorneygeneral.gov

Handles Toledo Bankruptcy Court

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Direct Fax: 866-452-9893
Main Line: 330-884-7500
Main Fax: 330-884-7551
Email:
jennifer.zap@ohioattorneygeneral.gov

1.27.15 updated

Handles Youngstown & Canton Bankruptcy Courts

COMMON GOVERNMENT CLAIMS

1. Ohio Department of Taxation
   - Sales
   - Income – Personal & Employer Withholding
   - Use
   - Corporate franchise
   - Commercial activity

2. Ohio Bureau of Workers' Compensation
   - Premiums
   - Non-compliance claims
   - Self-insured assessments
   - Benefit overpayments

3. Ohio Department of Job & Family Services
   - Contributions
   - Benefit overpayments
   - Franchise fees/Medicaid payments

4. Student Debt from 40+ State Universities
   - Student loans
   - Tuition payments
   - Room & board

5. Ohio Lottery Commission
   - Proceeds from agent ticket sales

6. Ohio Department of Development
   - Loans

7. Ohio Supreme Court
   - Client security funds
   - Fines for noncompliance on Attorney CLEs/registration
   - Attorney Disciplinary fines
   - Unauthorized practice of law fines

8. Environmental Protection Agency
   - Fines/penalties for air emissions, water issues

LIQUOR PERMITS IN BANKRUPTCY

A. Ohio Law

1. Ohio Department of Commerce, Division of Liquor Control ("DLC") is the governing body responsible for controlling the manufacture, distribution, licensing, regulation, and merchandising of beer, wine, mixed beverages, and spirituous liquor within Ohio pursuant to Ohio Revised Code Chapters 4301 and 4303. Regulatory functions include the issuance of permits to manufacturers, distributors and retailers of alcoholic beverages. As a "control state" all beer and intoxicating liquor must be bought and sold pursuant to Ohio law. DLC's website is at http://www.com.ohio.gov/liqr/ and has good information on how to transfer/renew liquor permits.

2. The Liquor Control Commission ("Commission") is the governing body responsible for ensuring compliance with the liquor laws and regulations of the state of Ohio and to provide fair and impartial hearings for the protection of the public and liquor permit holders. See O.R.C. § 4301.022, et. seq. The Commission works in conjunction with the DLC and the Ohio Department of Public Safety Investigative Unit. The Commission's website is at http://www.lcc.ohio.gov/.

3. Ohio law is clear that liquor permits are not property to which a security interest could attach. *Abraham v. Fioramonte* (1952), 158 Ohio St. 213, *Banc of America Strategic Solution, Inc. v. Cooker Restaurant Corp.*, Franklin App. No. 05AP-1126, 2006 Ohio 4567 (Ohio liquor permits may not be subject to a security interest).

4. Ohio law allows a liquor permit to be suspended or revoked for failure to pay any excise taxes – O.R.C. § 4301.25(A)(6).

5. Sales taxes are considered excise taxes – O.R.C. § 5739.02 as are BWC premiums, see *In re Suburban Motor Freight, Inc., supra.* for purposes or O.R.C. §301.25(A)(6).

6. Ohio law further prohibits the transfer of a permit if there are outstanding sales or withholding taxes. Ohio law requires DLC to check with the Ohio Department of Taxation ("Taxation") for delinquent sales and withholding taxes prior to transferring a permit. O.R.C. § 4303.26(B). DLC will not transfer a permit until it receives a "proceed letter" from Taxation.

7. The Commission can refuse to transfer or renew a liquor permit pursuant to O.R.C. § 4303.292 for failure to pay workers' compensation premiums or non-compliance claims. 2004 Op. Attorney General No. 2004-026.

8. The Commission can refuse to transfer or renew a liquor permit pursuant to O.R.C. § 4303.292 for failure to pay unemployment contributions. 1990 Op. Attorney General No. 1990-052. Unemployment contributions are excise taxes. *State ex. rel., Youngstown Sheet & Tube v. Leach*, (1962) 173 Ohio St. 397.

9. Ohio law prohibits any entity other than the named permit holder to conduct business under the permit. O.R.C.§4303.27. Therefore, management agreements to operate a business with a liquor permit between parties are not recognized by the State which must hold the permit holder (i.e. trustee) liable for all unremitted taxes and outstanding tax returns from the date of appointment (for trustees) through the date of actual transfer of the permit by DLC. The permit holder will further be responsible for any citations issued against the permit by DLC.

10. Ohio law allows an inactive permit be placed in safekeeping and is entitled to be renewed one time while in safekeeping. O.R.C. § 4303.272.

11. Ohio law requires annual renewal of a liquor permit. O.R.C. § 4303.271.

B. Federal Law

1. Bankruptcy law is clear that liquor permits are property of the bankruptcy estate to which security interests can attach. *In re Terwilliger's Catering Plus, Inc.*, 911 F. 2d 1168 (6th Cir. 1990) held that a valid pre-petition IRS lien took priority over any pre-petition debt owed to the State of Ohio. Court characterized O.R.C. § 4303.26(B) as giving the State a security interest in a liquor permit at transfer.

2. *In re Shary*, 152 B.R. 724 (Bankr. N.D. Oh. 1993) held that the State's failure to object to the sale motion or confirmation implicitly conveyed its consent to the sale pursuant to 11 U.S.C. § 363(f)(2). *Shary* further reinforced the notion that the State holds a security interest in the permit at the time of transfer as suggested by *Terwilliger's, supra.*

C. Useful Information to Transfer a Permit

1. Trustee should place non-operating permits in safekeeping pursuant to O.R.C. § 4303.272 as soon as possible to avoid having to file monthly sales tax returns on the vendor's license related to the permit. See DLC website at http://www.com.ohio.gov/liqr/. If the permit is not placed in safekeeping and not being operated, the trustee must continue to file monthly sales tax returns.

2.

3. Trustee must ensure annual renewal application for liquor permit is timely filed and paid with the Ohio Department of Commerce, Division of Liquor Control. To determine when the renewal period is for a permit, go to : http://www.com.ohio.gov/documents/LIQR_RenewalDistricts.pdf

4. Taxation requires the filing of all pre-petition tax returns as well as filing and payment of all post-petition tax returns related to liquor permits in bankruptcy.

5. If permit is being operated during bankruptcy, Taxation will require affidavits from trustee to ensure that all sales and withholding taxes are being correctly reported, taxes remitted and returns filed.

6. Trustee must have court authority to sell permit and other business assets to a third party – Ohio administrative code prohibits selling a "bare" permit. O.A.C. § 4301:1-1-14. – "when such transfer is in connection with the bona fide sale of the business or personal property assets of such permit holder…"

7. The "value" of the liquor permit (the sale price) should be clearly listed in the motion and order/notice authorizing the sale.

8. Properly notice the State of Ohio taxing authorities on any pleadings related to the sale and transfer of a liquor permit to avoid potential transfer issues. See Ohio Law, *supra*, and Section VI, Notices in Bankruptcy, *infra.*

NOTICES IN BANKRUPTCY

A. 11 U.S.C. § 342 requires a debtor provide notice to creditors at an address used in the last two mailings received from the creditor in the 90 days prior to the petition date or at a designated address.

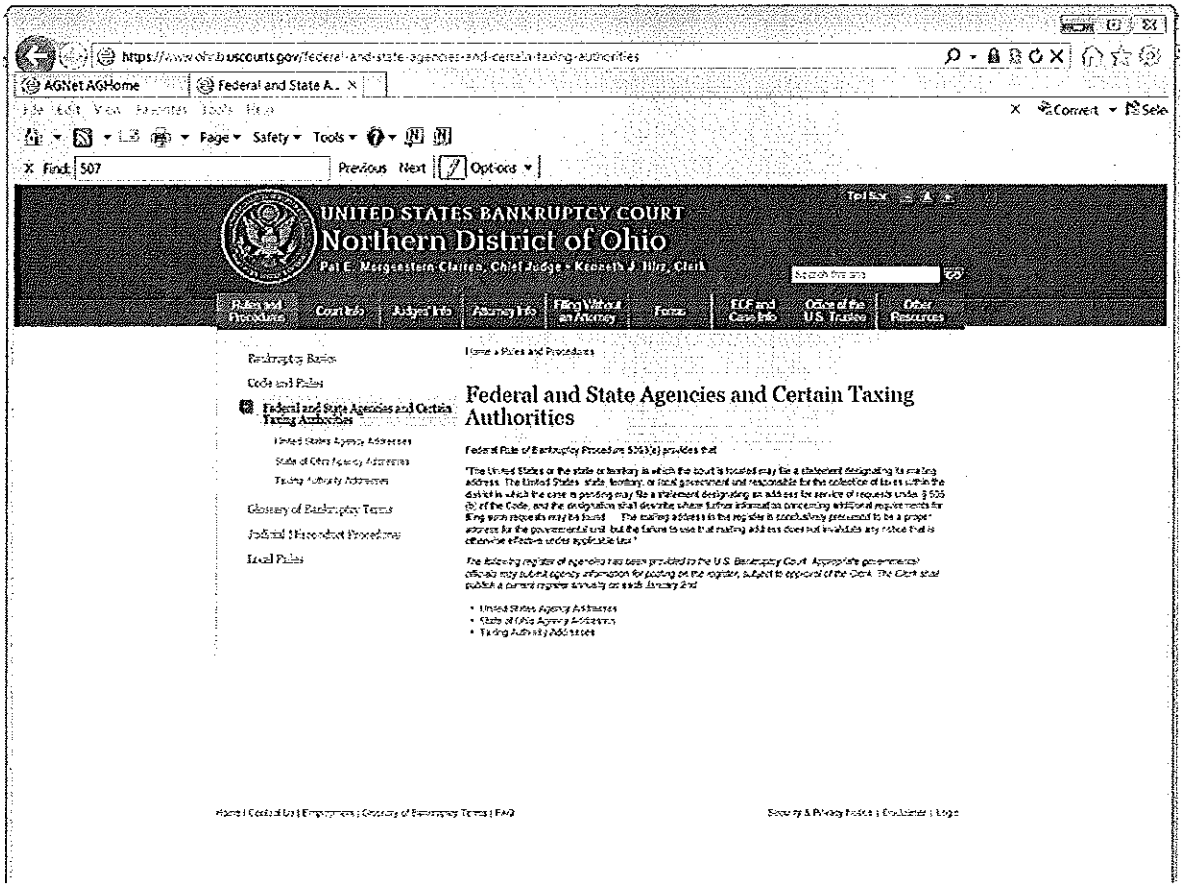
B. Federal Rule of Bankruptcy Procedure 5003(e) provides:

> The United States or the state or territory in which the court is located may file a statement designating its mailing address. The mailing address in the register is conclusively presumed to be a proper address for the governmental unit, but the failure to use that mailing address does not invalidate any notice that is otherwise effective under applicable law.

C. Ohio Rule of Civil Procedure 4.2(J) states that service of process shall be made as follows:

> Upon this state or any one of its departments, offices and Institutions as define in division (C) of section 121.01 of the Ohio Revised Code, by serving the officer responsible for the administration of the department, officer or institution or by serving the attorney general of this state:

D. Designated addresses for the State of Ohio can be found on the U.S. Bankruptcy Court, Northern District of Ohio website at http://www.ohnb.uscourts.gov/ These addresses have been updated to include service of §505 tax determination notices and constitutional challenges to state statutes.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Northern District of Ohio
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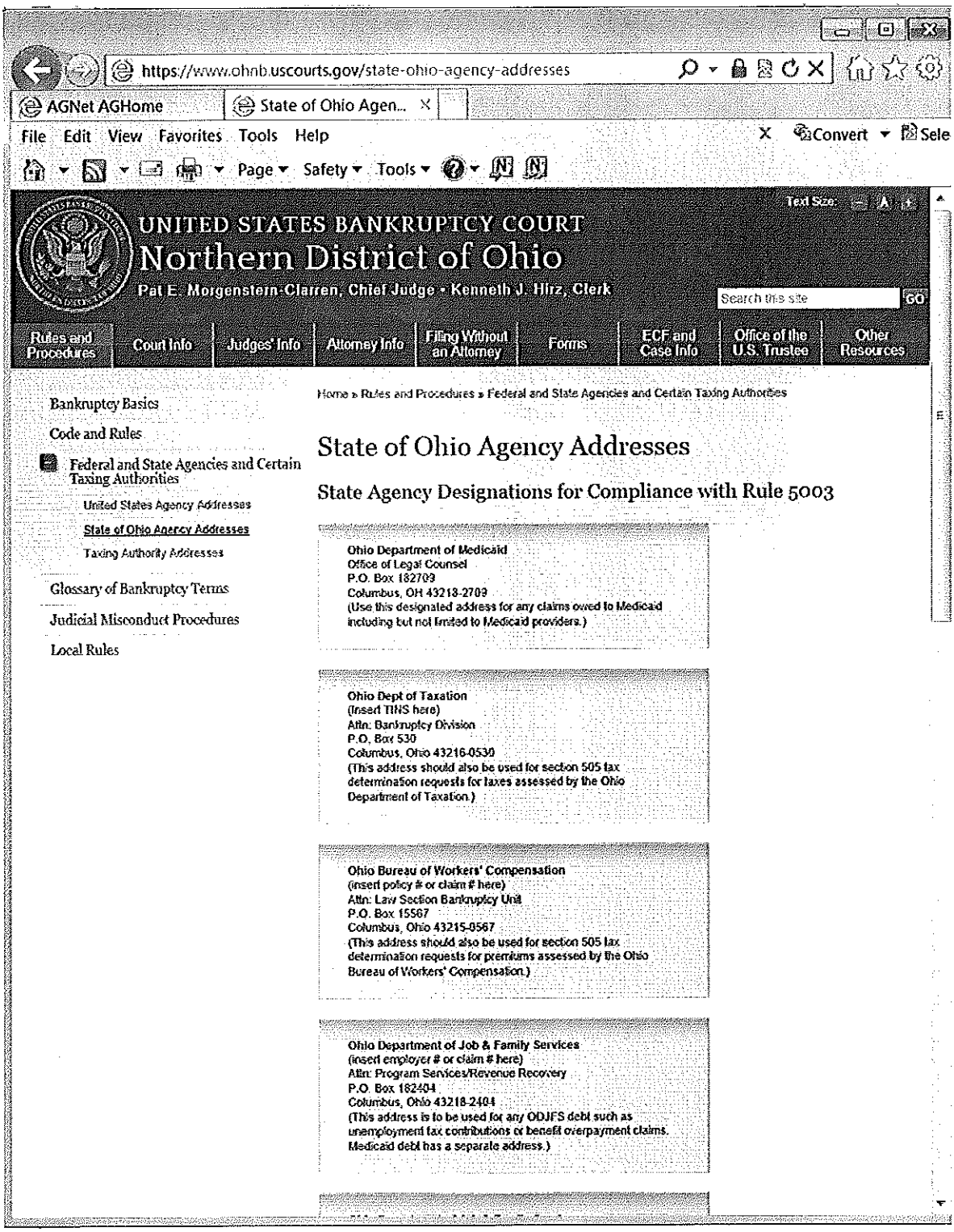
Forms
ECF and Case Info
Office of the U.S. Trustee
Other Resources
Bankruptcy Basics
Code and Rules
Federal and State Agencies and Certain Taxing Authorities
United States Agency Addresses
State of Ohio Agency Addresses
Taxing Authority Addresses
Glossary of Bankruptcy Terms
Judicial Misconduct Procedures
Local Rules
Home » Rules and Procedures
Federal and State Agencies and Certain Taxing Authorities
Federal Rule of Bankruptcy Procedure 5003(e) provides that
"The United States or the state or territory in which the court is located may file a statement designating its mailing address. The United States, state, territory, or local government unit responsible for the collection of taxes within the district in which the case is pending may file a statement designating an address for service of requests under § 505 (b) of the Code, and the designation shall describe where further information concerning additional requirements for filing such requests may be found. The mailing address in the registry is conclusively presumed to be a proper address for the governmental unit, but the failure to use that mailing address does not invalidate any notice that is otherwise effective under applicable law."
The following register of agencies has been provided to the U.S. Bankruptcy Court. Appropriate governmental officials may submit agency information for posting on the register, subject to approval of the Clerk. The Clerk shall publish a current register annually on each January 2nd.
• United States Agency Addresses
• State of Ohio Agency Addresses
• Taxing Authority Addresses
Home | Courts Info | Employment | Glossary of Bankruptcy Terms | FAQ
Security & Privacy Notice | Disclaimer | Logo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Northern District of Ohio
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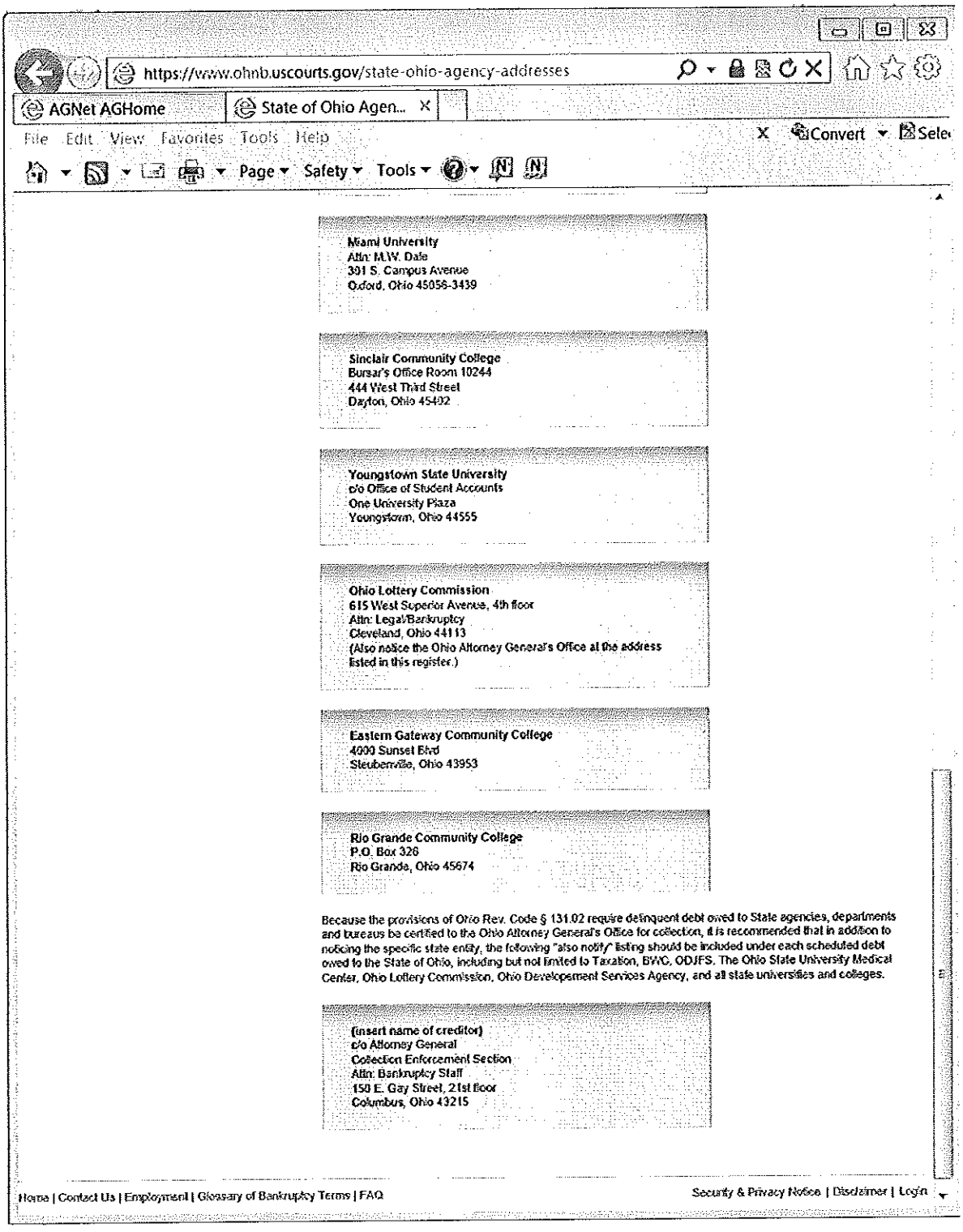
Federal and State Agencies and Certain Taxing Authorities
United States Agency Addresses
State of Ohio Agency Addresses
Taxing Authority Addresses
Glossary of Bankruptcy Terms
Judicial Misconduct Procedures
Local Rules
Home » Rules and Procedures » Federal and State Agencies and Certain Taxing Authorities
State of Ohio Agency Addresses
State Agency Designations for Compliance with Rule 5003
Ohio Department of Medicaid
Office of Legal Counsel
P.O. Box 182709
Columbus, OH 43218-2709
(Use this designated address for any claims owed to Medicaid including but not limited to Medicaid providers.)
Ohio Dept of Taxation
(Insert TINS here)
Attn: Bankruptcy Division
P.O. Box 530
Columbus, Ohio 43216-0530
(This address should also be used for section 505 tax determination requests for taxes assessed by the Ohio Department of Taxation.)
Ohio Bureau of Workers' Compensation
(insert policy # or claim # here)
Attn: Law Section Bankruptcy Unit
P.O. Box 15567
Columbus, Ohio 43215-0567
(This address should also be used for section 505 tax determination requests for premiums assessed by the Ohio Bureau of Workers' Compensation.)
Ohio Department of Job & Family Services
(insert employer # or claim # here)
Attn: Program Services/Revenue Recovery
P.O. Box 182404
Columbus, Ohio 43218-2404
(This address is to be used for any ODJFS debt such as unemployment tax contributions or benefit overpayment claims. Medicaid debt has a separate address.)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AGNet AGHome
State of Ohio Agen...
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Page Safety Tools
Miami University
Attn: M.W. Dale
301 S. Campus Avenue
Oxford, Ohio 45056-3439
Sinclair Community College
Bursar's Office Room 10244
444 West Third Street
Dayton, Ohio 45402
Youngstown State University
c/o Office of Student Accounts
One University Plaza
Youngstown, Ohio 44555
Ohio Lottery Commission
615 West Superior Avenue, 4th floor
Attn: Legal/Bankruptcy
Cleveland, Ohio 44113
(Also notice the Ohio Attorney General's Office at the address listed in this register.)
Eastern Gateway Community College
4000 Sunset Blvd
Steubenville, Ohio 43953
Rio Grande Community College
P.O. Box 326
Rio Grande, Ohio 45674
Because the provisions of Ohio Rev. Code § 131.02 require delinquent debt owed to State agencies, departments and bureaus be certified to the Ohio Attorney General's Office for collection, it is recommended that in addition to noticing the specific state entity, the following "also notify" listing should be included under each scheduled debt owed to the State of Ohio, including but not limited to Taxation, BWC, ODJFS, The Ohio State University Medical Center, Ohio Lottery Commission, Ohio Development Services Agency, and all state universities and colleges.
(insert name of creditor)
c/o Attorney General
Collection Enforcement Section
Attn: Bankruptcy Staff
150 E. Gay Street, 21st floor
Columbus, Ohio 43215
Home | Contact Us | Employment | Glossary of Bankruptcy Terms | FAQ
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E. It is strongly recommended that you use the addresses as listed on the Northern District website when preparing the Debtor's schedule and petition in order to provide proper notice to the State creditors. This is particularly important as all of the State of Ohio taxing authorities (Taxation, BWC & ODFJS) file their own proofs of claims in bankruptcy cases.

F. Most of the State of Ohio taxing authorities are currently using or will be using the Electronic Bankruptcy Noticing process to receive notices and other pleadings disseminated by the Court; Debtor's use of the designated addresses will facilitate that process.

G. Common **mistakes on notice** include:

1. Using post office box for personal income tax returns as address for Taxation– not advisable anytime of the year but particularly not during tax season.

2. Using district office addresses for any taxing authorities.

3. Noticing the Ohio Attorney General or outside counsel but not the actual taxing authority. Failure to notice the actual taxing authority may result in a nondischargeable debt not being proofed or paid.

4. Not using the State designated addresses on the bankruptcy court websites or not calling our office when you have a question on noticing a state creditor – JUST ASK to avoid later explaining to your client why the debt is either now not discharged for failure to properly notice the State creditor or why the non-dischargeable debt was not paid through the bankruptcy.

363 Sale Issues

1. Sales of property "free & clear" pursuant to § 363(f) does not extinguish the debtor's experience rating for unemployment contributions which can be used to determine the purchaser's unemployment contribution rate pursuant to State law. *In re Wolverine Radio Company*, 930 F.2d. 1132 (6th Cir. 1991).

2. Debtor's unemployment experience rate is not a claim, debt or interest that can be extinguished by § 363(f), *Id.* at 1145-1146.

3. Michigan unemployment system certified as complying with requirements of Federal Unemployment Tax Act for experience based tax rate and as part of a comprehensive federal-state system provides for security of unemployed workers does not conflict with federal bankruptcy law. *Id* at 1146.

4. Bankruptcy Code should not provide purchaser with a more preferable tax rate than employers who purchase the assets of a predecessor not in bankruptcy. *Id.* At 1149.

Pros and Cons of Business
Chapter 7

BUSINESS CHAPTER 7 BEST PRACTICES

Pros & Cons of Business Chapter 7

HAROLD A. CORZIN CHAPTER 7 TRUSTEE
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Hcorzin@csu-law.com

NORTHERN DISTRICT OF OHIO
BENCH BAR RETREAT

OCTOBER 30, 2015

Please consider the following before filing a liquidation proceeding (Chapter 7 for a corporation, LLC or partnership):

A. Corporations do not receive a discharge. 11 U.S.C. §727 recites that "the court shall grant the debtor a discharge unless...the debtor is not an individual". While it is not unusual for a business entity in a rehabilitation proceeding to convert the case or have the case converted to a Chapter 7 proceeding counsel who initially files the case as Chapter 7 must understand that the business entity does not continue its existence and is liquidated by the Chapter 7 trustee.

B. Business entities other than individuals operating a business enterprise as a sole proprietorship (and thus files a Schedule C together with the federal tax return) are not provided with any exemptions. Bankruptcy Schedule C should thus be left blank or the practitioner may insert the word "none". See 11 U.S.C. §522(b)(1). Thus, upon liquidation neither the business entity nor its shareholders generally will have any claim of right to estate property or resulting proceeds of sale.

C. Other than in the case of conversion from a Chapter 11 proceeding to a Chapter 7, in my experience the great majority of business 7s is filed by small businesses which are often service related. Creditors do not often provide loans to the business entity without obtaining the guarantee of one or more principals. Filing a Chapter 7 liquidation proceeding on behalf of the business entity will not provide any protection to the guarantor or surety (except, perhaps, delaying litigation which has already been filed with both the business and the principal named as party defendants) and the business's co-obligor remains responsible for payment of the obligation which often times results in a concurrent insolvency proceeding. There is no co-debtor stay in Chapter 7 proceedings unlike the co-debtor stay provided in Chapter 13 cases pursuant to the provisions of 11 U.S.C. §1301. Corporate and other business entities are ineligible to be a debtor in a Chapter 13 proceeding.

D. Business entities such as corporations, LLCs and partnerships must be represented by counsel. There are no *pro se* business bankruptcies with the exception of sole proprietors. The Supreme Court of Ohio has exclusive authority under Article IV of the Ohio Constitution to regulate the practice of law. See Article IV of the Ohio Constitution, Section 2(B). Only an attorney licensed in the state may file an insolvency proceeding on behalf of a corporate or other business entity.

E. In most circumstances best practices would dictate that should the business entity and its principal/co-obligor both seek bankruptcy protection, two counsel should be utilized, one to represent the business entity and one to represent the individual. All too often there are conflicts of interest which preclude one attorney from representing both the business and its majority or sole shareholder. Small businesses often rely upon cash infusions by corporate ownership. You must be careful to ensure that you are not representing both the corporation and a creditor of the corporation. All too often this ethical consideration is overlooked.

F. While partnerships may file Chapter 7 proceedings the results are never very

pretty. You are strongly discouraged from even thinking about this course of action. See the provisions of 11 U.S.C. §723 which is being appended hereto for your convenience. Do you really want to expose all of the general partners to the collection efforts of the Chapter 7 trustee?

G. Neither the debtor, the debtor's principal nor counsel maintain any control over the liquidation process. Trustees typically act as expeditiously as possible. This typically results in liquidation proceeds which are less than if the business entity, by the efforts of its principals and agents, sold the assets of the business. Liquidation of business assets outside of the bankruptcy arena typically produces a greater return to creditors than that provided by the bankruptcy fiduciary. Furthermore, and as you almost certainly understand, most small businesses have few if any assets which are not subject to security interests.

The only logical reason for the filing of a Chapter 7 for a corporation or LLC is the easy, orderly liquidation of the business's assets saving the principal the rigors of dealing with pesky business creditors. In essence, the insolvency proceeding takes the place of the wind down and formal dissolution required under Ohio law. Please refer to ORC 1701.86.

Finally, your attention is drawn to the fact that when businesses run into financial difficulties, are sued by creditors and become judgment debtors with respect to significant obligations it is not unusual for counsel to tell the principal "lets stop the business operations of John's Painting, Inc. and thereafter restart business operations with a new corporate identity known as John's Good Painting, Inc." In that fashion business continues but is conducted by a different corporate entity notwithstanding the fact that the shareholders and other principals remain the same, that work in progress continues as if nothing happened and that there will almost always be the wholesale transfer of the assets of the old business to the new one. Please recall that business assets are not confined to tangible assets but also include goodwill, telephone numbers, websites, customer lists, accounts receivable and other specific and general intangibles. It makes more sense to put the failing business into Chapter 7, have a trustee calculate the value of all business assets, tangible and intangible, and then work something out whereby the principal purchases the assets from the trustee and then transfers the assets, tangible and intangible, to the principal or, if the new entity has already been established, the sale could be from the trustee directly to the new business entity. This will typically avoid having to defend your client from legal actions predicated upon alter-ego theory and successor liability.

Title 11 Liquidation Subchapter II
–
Collection, Liquidation, and Distribution of the Estate

TITLE 11 - BANKRUPTCY
CHAPTER 7 - LIQUIDATION
SUBCHAPTER II - COLLECTION, LIQUIDATION, AND DISTRIBUTION OF THE ESTATE

§ 723. Rights of partnership trustee against general partners

(a) If there is a deficiency of property of the estate to pay in full all claims which are allowed in a case under this chapter concerning a partnership and with respect to which a general partner of the partnership is personally liable, the trustee shall have a claim against such general partner to the extent that under applicable nonbankruptcy law such general partner is personally liable for such deficiency.

(b) To the extent practicable, the trustee shall first seek recovery of such deficiency from any general partner in such partnership that is not a debtor in a case under this title. Pending determination of such deficiency, the court may order any such partner to provide the estate with indemnity for, or assurance of payment of, any deficiency recoverable from such partner, or not to dispose of property.

(c) The trustee has a claim against the estate of each general partner in such partnership that is a debtor in a case under this title for the full amount of all claims of creditors allowed in the case concerning such partnership. Notwithstanding section 502 of this title, there shall not be allowed in such partner's case a claim against such partner on which both such partner and such partnership are liable, except to any extent that such claim is secured only by property of such partner and not by property of such partnership. The claim of the trustee under this subsection is entitled to distribution in such partner's case under section 726 (a) of this title the same as any other claim of a kind specified in such section.

(d) If the aggregate that the trustee recovers from the estates of general partners under subsection (c) of this section is greater than any deficiency not recovered under subsection (b) of this section, the court, after notice and a hearing, shall determine an equitable distribution of the surplus so recovered, and the trustee shall distribute such surplus to the estates of the general partners in such partnership according to such determination.

(Pub. L. 95–598, Nov. 6, 1978, 92 Stat. 2606; Pub. L. 98–353, title III, § 476, July 10, 1984, 98 Stat. 381; Pub. L. 103–394, title II, § 212, Oct. 22, 1994, 108 Stat. 4125; Pub. L. 111–327, § 2(a)(26), Dec. 22, 2010, 124 Stat. 3560.)

Historical and Revision Notes

legislative statements

Section 723(c) of the House amendment is a compromise between similar provisions contained in the House bill and Senate amendment. The section makes clear that the trustee of a partnership has a claim against each general partner for the full amount of all claims of creditors allowed in the case concerning the partnership. By restricting the trustee's rights to claims of "creditors," the trustee of the partnership will not have a claim against the general partners for administrative expenses or claims allowed in the case concerning the partnership. As under present law, sections of the Bankruptcy Act [former title 11] applying to codebtors and sureties apply to the relationship of a partner with respect to a partnership debtor. See sections 501 (b), 502 (e), 506 (d)(2), 509, 524 (d), and 1301 of title 11.

senate report no. 95–989

This section is a significant departure from present law. It repeals the jingle rule, which, for ease of administration, denied partnership creditors their rights against general partners by permitting general partners' individual creditors to share in their estates first to the exclusion of partnership creditors. The result under this section more closely tracks generally applicable partnership law, without a significant administrative burden.

Subsection (a) specifies that each general partner in a partnership debtor is liable to the partnership's trustee for any deficiency of partnership property to pay in full all administrative expenses and all claims against the partnership.

Subsection (b) requires the trustee to seek recovery of the deficiency from any general partner that is not a debtor in a bankruptcy case. The court is empowered to order that partner to indemnify the estate or not to dispose of property pending a determination of the deficiency. The language of the subsection is directed to cases under the bankruptcy code. However, if, during the early stages of the transition period, a partner in a partnership is proceeding under the

Bankruptcy Act [former title 11] while the partnership is proceeding under the bankruptcy code, the trustee should not first seek recovery against the Bankruptcy Act partner. Rather, the Bankruptcy Act partner should be deemed for the purposes of this section and the rights of the trustee to be proceeding under title 11.

Subsection (c) requires the partnership trustee to seek recovery of the full amount of the deficiency from the estate of each general partner that is a debtor in a bankruptcy case. The trustee will share equally with the partners' individual creditors in the assets of the partners' estates. Claims of partnership creditors who may have filed against the partner will be disallowed to avoid double counting.

Subsection (d) provides for the case where the total recovery from all of the bankrupt general partners is greater than the deficiency of which the trustee sought recovery. This case would most likely occur for a partnership with a large number of general partners. If the situation arises, the court is required to determine an equitable redistribution of the surplus to the estate of the general partners. The determination will be based on factors such as the relative liability of each of the general partners under the partnership agreement and the relative rights of each of the general partners in the profits of the enterprise under the partnership agreement.

Amendments

2010—Subsec. (c). Pub. L. 111–327 substituted "The trustee has" for "Notwithstanding section 728 (c) of this title, the trustee has".

1994—Subsec. (a). Pub. L. 103–394 substituted "to the extent that under applicable nonbankruptcy law such general partner is personally liable for such deficiency" for "for the full amount of the deficiency".

1984—Subsec. (a). Pub. L. 98–353, § 476, substituted provisions that the trustee shall have a claim for the full amount of the deficiency against a general partner who is personally liable with respect to claims concerning partnerships which are allowed in a case under this chapter, for provisions that each general partner in the partnership would be liable to the trustee for the full amount of such deficiency.

Subsec. (c). Pub. L. 98–353, § 476(b), substituted "such partner's case" for "such case" in two places, "by property of such partnership" for "be property of such partnership", and "a kind specified in such section" for "the kind specified in such section".

Effective Date of 1994 Amendment

Amendment by Pub. L. 103–394 effective Oct. 22, 1994, and not applicable with respect to cases commenced under this title before Oct. 22, 1994, see section 702 of Pub. L. 103–394, set out as a note under section 101 of this title.

Effective Date of 1984 Amendment

Amendment by Pub. L. 98–353 effective with respect to cases filed 90 days after July 10, 1984, see section 552(a) of Pub. L. 98–353, set out as a note under section 101 of this title.

Attorney Client Privilege in Chapter 11 Reorganization

THE ATTORNEY CLIENT PRIVILEGE IN CHAPTER 11 REORGANIZATIONS

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I. OVERVIEW

The attorney client privilege of a corporate debtor passes to the trustee in any bankruptcy proceeding. In a chapter 11 proceeding, the debtor, as debtor-in-possession, often acts as trustee. Since a corporate entity is inanimate, it must act through agents, which are generally the directors and officers of a corporation. A debtor-in-possession and its attorney-client privilege will therefore generally be controlled by pre-bankruptcy management. However, in the event that some other person or group of persons comes into functional control of the corporate entity, the control of the entity's attorney-client privilege can and likely (but not in all cases) will pass with it. The corporate debtor's attorney-client privilege can also be passed to a litigation trust by operation of a chapter 11 plan, even if that trust is more accurately a successor-in-interest to a creditors' committee than to the debtor—in fact, a trust may inherit control of both the committee's and debtor's attorney-client privilege.

II. *WEINTRAUB* AND CORPORATE PRIVILEGE IN BANKRUPTCY GENERALLY

Control of the attorney client privilege passes with the control of a corporate entity, and when a trustee takes control of a bankrupt corporate debtor's assets, it is considered such a change in control. This is the principal lesson of *Commodity Futures Trading Com. v. Weintraub*, 471 U.S. 343 (1985). The *Weintraub* Court embraced a functional analysis of where control of the attorney-client privilege passes in a bankruptcy case:

> In light of the lack of direct guidance from the Code, we turn to consider the roles played by the various actors of a corporation in bankruptcy to determine which is most analogous to the role played by the management of a solvent corporation. *See Butner v. United States*, 440 U.S. 48, 55 (1979). Because the attorney-client privilege is controlled, outside of bankruptcy, by a corporation's management, the actor whose duties most closely resemble those of management should control the privilege in bankruptcy, unless such a result interferes with policies underlying the bankruptcy laws.

Weintraub at 351-52.

While this case involved a chapter 7 debtor, it has been applied more broadly, including in the chapter 11 context. The *Weintraub* court also clearly contemplated such broader application because, while not mentioning chapter 11 specifically, it discussed debtors in possession, a concept foreign to chapter 7, *id.* at 355, and cited various provisions of 11 U.S.C. § 1106 (duties of a chapter 11 trustee) in listing the extensive powers and duties of a bankruptcy trustee that led to the conclusion that the trustee, not the debtor, controls the corporate entity. *Id.* at 352.

However, *Weintraub* involved a comparatively simple fact pattern: A defunct chapter 7 debtor with no operating successor. Applying the *Weintraub* Court's analogous-duties rule in more complex bankruptcy cases can get correspondingly more complex.

III. LIQUIDATION/LITIGATION TRUSTS

Liquidation or litigation trusts are a common feature of chapter 11 reorganizations. The trustees of such liquidation trusts can sometimes invoke (and waive) the privilege of both the debtor *and* the official committee of unsecured creditors—intentionally or inadvertently.

Official Committee of Unsecured Creditors of Hechinger Inv. Co. of Del. v. Fleet Retail Fin. Group (In re Hechinger Inv. Co. of Del., Inc.), 285 B.R. 601 (D. Del. 2002):

The law firm of Chadbourne and Park represented the debtors prior to their bankruptcy with respect to certain transactions in 1997. Later, two attorneys from Chadbourne moved to Gibson Dunn & Crutcher, which later represented the individual defendants. They took with them certain documents related to those 1997 transactions when they switched firms. Chadbourne never represented the individual directors and officers; Gibson Dunn never represented the corporate entities.

Hechinger filed for bankruptcy in 1999. The assets of Hechinger Investment Company were liquidated in a liquidating chapter 11 plan. There was no operating successor; all assets of the debtors, including causes of action, were transferred to a liquidation trust formed as a successor to the official committee of unsecured creditors pursuant to the plan.

The trust brought an adversary proceeding against Hechinger's former directors and officers regarding pre-bankruptcy transactions. They sought discovery of the documents related to the 1997 transactions from Gibson Dunn. Gibson Dunn argued that the documents were privileged and that the privilege was still held by the directors and officers of the corporation, arguing that *Weintraub* "only held that a trustee succeeding to the management of a ... debtor had the right to waive the attorney-client privilege," implying that the liquidation trustee, as a successor to the committee, was not, even though it held all assets of the debtor.

Two other defendants then responded and argued that if the privilege passed to the trust, then the trust had waived it (or, perhaps, the debtors had waived it even prior to the formation of the trust, though this is not directly explored in the decision) and the documents should be discoverable by all parties, not just turned over to the liquidation trustee: the fact that the directors and officers were adverse parties and were in possession of the documents meant that the confidentiality necessary to preserve privilege had been broken.

The Court held that (1) the trust held the privilege, and (2) the trust had waived the privilege because the documents sought had been in possession of the individual directors and officers since at least the beginning of the adversary litigation (in 2000) and possibly since the beginning of the bankruptcy case (in 1999).

Therefore, Gibson Dunn was ordered to disclosed the formerly-privileged communications to *all* defendants.

Am. Int'l Specialty Lines Ins. Co. v. NWI-I Inc., 240 F.R.D. 401 (N.D. Ill. 2007):

This decision arising in the Fruit of the Loom bankruptcy is the rare example of a case in which a court held a plan provision expressly purporting to assign the attorney-client privilege was held unenforceable. Critically, (1) the plan purported to assign the corporate debtor's attorney-client privilege to *multiple* successor entities, and (2) there was an actual operating successor entity carrying on the business of the old debtor.

The confirmed joint plan of reorganization in the FTL bankruptcy designated six separate successor entities to the old FTL debtors. Two of these entities were a Custodial Trust (CT) and Successor Litigation Trust (SLT). Neither one of these took over the operating assets of FTL's apparel business; the CT existed to hold seven properties that were the subject of environmental litigation by the EPA and a pollution exclusion in a $100 million insurance policy covering those properties, and the SLT existed mostly to liquidate assets to fund the CT. FTL's apparel business was taken over by a new entity that purchased substantially all of the old debtors' assets and continued to operate that business. In addition, the old FTL was reorganized as a wholly-owned subsidiary of the SLT.

The plan purported to give control of the attorney client privilege to both trusts:

> In connection with the rights, claims and causes of action that constitute the [Successor Liquidation Trust Assets or the Custodial Trust Assets], any attorney-client privilege, work-product privilege, or other privilege or immunity attaching to any documents or communications (whether written or oral) transferred to the [SLT or CT] shall vest in the [SLT or CT] and

its representatives, and the Parties are authorized to take all necessary actions to effectuate the transfer of such privileges.

However, analyzing the "practical consequences" of the multiple transactions undertaken pursuant to the plan, the court concluded that the only entity that acquired the right to assert or waive the old debtors' privilege was the operating successor, relying on an earlier case holding:

> If the practical consequences of the transaction result in the transfer of control of the business and the continuation of the business under new management, the authority to assert or waive the attorney-client privilege will follow as well.

Id. at 406 (quoting *Soverain Software LLC v. Gap, Inc.*, 340 F. Supp. 2d 760, 763 (E.D. Tex. 2004).

The court noted that a plan provision vesting the privilege is not necessarily dispositive, and was also highly reluctant to "allocat[e] the attorney-client privilege based on the division of a debtor's assets to multiple successor entities." Therefore, the CT and SLT were not entitled to assert or waive the privilege as it pertained to documents or communications, pre- or postpetition, between the old debtors and their attorneys.

In re FLAG Telecom Holdings Secs. Litig., 2009 U.S. Dist. LEXIS 124061, 2009 WL 5245734 (S.D.N.Y. Jan. 14, 2009):

If you ever find yourself citing *NWI-I*, above, in support of control of the attorney-client privilege being simply an incident of control of the corporation, consider a *"but see"* citation for *Flag Telecom*, and vice versa.

In this chapter 11 case, the confirmed plan created (a) a reorganized debtor that emerged from bankruptcy free and clear as FLAG Telecom's successor, and (b) a litigation trust, which held only the debtors' "claims for relief, causes of action, debts, losses, and liabilities." The litigation trust agreement expressly granted the trust the authority to "collect documents relating to the transferred causes of action and [to control] related [attorney client] privileges." *Id.* at 5. The litigation trust brought causes of action against the former directors and officers of the debtors, and a dispute arose between the litigation trustee and a former in-house counsel for the debtor (who was by that time an attorney for the reorganized debtor) over who controlled the old debtor's privilege.

The court distinguished both *Weintraub* and *NWI-I*, and held that the provision of the trust empowering the trustee to hold the attorney-client privilege related to the documents was valid and enforceable, and that the trustee, not the reorganized debtor, had sole control of the privilege with respect to the old debtor's documents and communications related to the transferred causes of action.

Distinguishing *Weintraub*, the court first noted that there was no express plan provision vesting the attorney-client privilege in that case (there wouldn't be, given that it was a chapter 7 case). The *FLAG Telecom* court further held that the *Weintraub* functionalist/"close resemblance" language leaned in favor of the litigation trust holding the privilege with respect to the documents, since the function of the litigation trust—bringing actions against the directors and officers of the old debtor—was a function that would have belonged to the corporation, just as much as operating the business.

Distinguishing *NWI-I*, the court held that dividing up the attorney-client privilege was a less complex matter in *FLAG Telecom* than it would have been in Fruit of the Loom, because there were only two entities, the transactions that created them were less complex, and the assets transferred to the litigation trust were sufficiently discrete. in addition, the court held that the nature of the litigation claims transferred was relevant as well: in *NWI-I*, the cause of action involved environmental liability; in *FLAG Telecom*, it involved D&O liability, and the "practical consequences" of denying the litigation trustee the ability to waive the attorney-client privilege of the debtor corporation would deny the litigation trustee one of the "arrows in its litigation quiver" that the debtor itself would have enjoyed had it never filed bankruptcy and brought the action against the directors and officers itself.

Query whether those grounds for distinguishing *Weintraub* and *NWI-I* should actually stand up to scrutiny.

Osherow v. Vann (In re Hardwood P-G, Inc.), 403 B.R. 445 (Bankr. W.D. Tex. 2009):

Note that litigation trusts can be successors in interest to committees as well as debtors, and therefore can inherit the attorney-client privileges of both.

The debtors in this case employed a forensic accounting firm to investigate the debtors' potential causes of action for preferential and fraudulent transfers. The committee's counsel also prepared a report for the committee regarding preferential and fraudulent transfers. The committee counsel was later (but pre-confirmation) also appointed special counsel to the debtor to pursue certain of those preference claims.

Upon confirmation, the plan provided for the creation of a litigation trust, expressly stated to be successor to the committee, and assignee of the avoidance actions:

> In addition to the Litigation Trust being the assignee of the Avoidance Actions and Litigation Claims, the Litigation Trust shall be deemed to be a successor-in-interest to the Committee ...

Id. at 451. The committee ceased to exist on the effective date of the plan, and the trust retained the committee's prior counsel.

An avoidance action defendant sought discovery from the trustee of the forensic accounting report originally performed by the debtor's accountant and the litigation report originally prepared by committee counsel. The trustee asserted the debtor's attorney-client privilege with respect to the accounting report and the committee's attorney-client privilege with respect to the litigation report (along with other theories as to why the documents should not be produced, including the common-interest doctrine and work-product doctrine). The court agreed: "The Trustee is now the holder of the privilege of both the debtors and the Committee and may thus assert such privilege as to both Reports." *Id.* at 461.

IV. CONCLUSION AND BEST PRACTICES

At the start of a chapter 11 bankruptcy case, the trustee controls the corporate debtor's privilege; if the trustee is the debtor-in-possession, then little will change as a practical matter. The central question is whose duties are most analogous to those of the pre-bankruptcy corporate management's. An appointed committee will not share the debtor's privilege.

However, the operation of a confirmed plan, particularly one that creates both an operating successor of the debtor and a litigation trust to pursue causes of action belonging to the debtor, can muddy the waters considerably. Confirmed plans can result in one post-confirmation entity controlling the attorney-client privilege of two or more pre-confirmation entities, and can even result in two or more post-confirmation entities dividing up the privilege previously controlled by a single pre-confirmation entity, though the latter is less favored. Express language in a plan vesting control of the attorney-client privilege post-confirmation in a particular entity is persuasive but not controlling and there are differences among courts as to how much weight such language should be accorded.

Therefore, counsel should the following in mind:

- When representing a prospective purchaser of substantially all of the assets of a bankrupt corporation, keep in mind that the privilege attached to some or all of the communications might pass to a litigation trust and not to your client. To the extent that control of the privilege matters to your client, it should ideally be stated expressly in the plan, though if the plan is merely silent on it, the default rule is likely in your favor.

- When representing a corporation in bankruptcy, be mindful of the fact that there are multiple potential future entities that could obtain the right to waive the privilege in your communications with your client, and that in a *FLAG Telecom* scenario, it is possible that some of your communications' privilege might be controlled by one post-confirmation entity and some by another. That said, be mindful that you still also need to represent your client in the here and now (potentially even against the individual directors and officers).

- Directors and officers of corporations considering filing for bankruptcy should have their own counsel separate from the corporation's counsel. (This should be the case even if the company is not in financial distress, of course, but it acquires more urgency in a distressed-enterprise context.) If you are that counsel, be sure that communications regarding potential director and officer liability pass through you and not through general corporate channels outside the circle in which you can claim the directors' and officers' personal privilege.

- When representing a committee with the strength to shape a chapter 11 plan, particularly if considering action against the debtor's individual directors and officers, you will very likely want a plan that creates a litigation trust that succeeds simultaneously to both the debtor and the committee and acquires (and can waive) the privilege of both.

A Practical Approach to Credit Bidding in Bankruptcy

A Practical Approach to Credit Bidding in Bankruptcy

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Despite numerous well-publicized challenges and apparent erosions to the rights of secured parties to credit bid their first-position debt in sales conducted under Section 363 of the Bankruptcy Code, when a practical approach is used by parties seeking to sell assets in Bankruptcy, Section 363(k) should still grant secured parties the right to use their debt to protect their interests in collateral by credit bidding.

Authority Guiding Credit Bid Rights

1. Section 363(k) provides the path for secured creditors to credit bid by stating that "[a]t a sale under subsection (b) of this section of property that is **subject to a lien** that secures an **allowed claim**, unless the court for cause orders otherwise, the holder of such claim may bid at such sale, and if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property.

    a. The language "subject to a lien" is determinative and extremely important. An area where Courts and other parties can successfully minimize the use of credit bid rights by a secured creditor is where the secured creditor's interest in collateral of the debtor is limited. Said differently, a creditor must have an interest (generally a senior interest) in the property being sold in order for its 363(k) credit bid rights to be recognized. In *Beal Bank, S.S.B., v. Waters Edge Limited P'ship*, 248 B.R. 668, 679-80 (D. Mass. 2000) the court held that if a creditor has a lien on other property that is not part of the sale, then there is no right to credit bid. Where a creditor seeks to make use of credit bid rights and its interest in the property (or priority) is challenged, a cloud on the right to credit bid can form or cause limitation.

    b. Section 363(k) requires that a creditor's right to credit bid be related to a claim that is "allowed." In the case of a secured creditor with a senior position in the collateral, this may seem a formality, however, where challenge is posed by the debtor (or other parties), an expected to be allowed claim can create reason for delay or require determination from the Court. Despite the requirement that a claim be allowed, where a purported first position secured creditor's claim is being challenged, Courts have developed ways for such party(ies) to make use of Section 363(k) without issuing an order allowing or disallowing a claim. *See, e.g.,*

In re Octagon Roofing, 123 B.R. 583, 588 (Bankr. N.D. Ill. 1991) (an irrevocable letter of credit provided by the secured creditor/credit bidder created an avenue for the credit bid to be in play while allowance of the claim remained an open issue).

c. Notably, notwithstanding the requirement that a credit bid be limited to a creditor's allowed claim and that it be tied to a genuine interest in collateral, in situations where a secured creditor is the holder of a "blanket lien," such creditor usually has great flexibility to use its credit bid, regardless of any perceived value of the collateral in question. *See, e.g. Cohen v. KB Mezzanine Fund II, LP (In re SubMicron Sys. Corp.)*, 432 F. 3d 448, 459-60 (3d Cir. 2006) (holding that capping credit bids of a lender holding an interest in all the assets being sold is "nonsensical" because the lender's bid becomes the value of the collateral, up to the entire amount of its claim(s)).

d. As a final note to the mechanics of credit bidding, in 2012 the United States Supreme Court settled a Circuit Court split by holding that credit bid rights under Section 363(k) extended to sales conducted in and through a plan of reorganization under Section 1129(b)(2)(A)(ii) & (iii) of the Bankruptcy Code. *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 132 S. Ct. 2065 (2012) (holding that the specific language of Section 1129(b)(2)(A)(ii) trumps Section 1129(b)(2)(A)(iii) and that despite any "indubitable equivalence" that may be provided in a plan for the secured creditor, the secured creditor's right to choose its remedy by credit bidding remains in force).

2. Recently, courts have expanded "cause" to limit the credit bid rights of some secured creditors.

a. In two relatively recent decisions, courts have used "cause" as a reason to promote bidding at an auction under Section 363. First, in *In re Fisker Automotive Holdings, Inc.*, 510 B.R. 55 (Bankr D. Del. 2014) the Court specifically stated that "cause" is not limited to situations where the creditor has engaged in inequitable conduct, holding that the "court may deny a lender the right to credit bid in the interest of any policy advanced by the [Bankruptcy] Code, such as to ensure the success of the reorganization or to foster a competitive bidding environment." Fearing that a lender who purchased the claim at a deep discount, would use the credit bid rights as a shield to freeze out bidder interest, the Delaware court found cause existed and limited the credit bid rights of the lender. *See id.* Second, following the Delaware court's lead in *Fisker*, the bankruptcy court from the Eastern District of Virginia limited a secured creditor's right to credit bid when it found the creditor (i) had installed an "overly-zealous loan to own strategy," including a highly aggressive sales process; (ii) had mis-filed its UCC financing statements against the debtor

(asserting interests in assets that were not granted); and (iii) created general confusion to the process. *In re Free Lance-Star Publishing Co.*, 512 B.R. 798 (Bankr. E.D. Va. 2014). The Virginia court used "cause" stating that a "perfect storm" was caused providing an environment for "curtailment" of the secured creditor's credit bid rights.

b. Collusion between bidders or a bidder and the debtor/trustee can create a situation for cause to be invoked by the court and limit or eliminate credit bid rights. *In re Theroux, 169 B.R. 498, 499 (Bankr. D.R.I. 1994)* (holding that when a procedure is proposed that can only benefit the secured creditor, while inflicting damage on other parties (in this case taxing authorities), may be evidence of collusion and justify modification to credit bid rights).

c. Legitimate disputes as to the collateral interest of a secured party can serve as cause (although it could also result in a situation to fail to satisfy Section 363(k) generally). *Morgan Stanley Dean Witter Mortgage Capital, Inc. v. Alon USA, L.P. (In re Akard Street Fuels, L.P.)*, 2001 WL 1568332 at *3 (N.D. Tex. Dec. 4, 2001) (holding that determination of the collateral secured by the security interest would be lengthy and credit bid rights could impair the sale process).

d. Other circumstances have resulted in Courts deciding to modify, curtail or eliminate credit bid rights. Generally, each situation presents facts that indicate that the parties were attempting efforts that raised scrutiny and gave the courts reason for pause.

e. Each of the referenced cases represent situations where the parties (generally secured parties) seeking to use credit bid rights had legitimate issues as to whether their credit bid rights were intact or justified. Moreover, at least one post-*Fisker* and *Free Lance-Star* court expressed that modification of credit bid rights for cause should be applied very carefully stating that it required "extraordinary circumstances" to order limitations. *In re RML Development Inc.*, 2014 WL 3378578 (Bankr. W.D. Tenn. July 10, 2014) (chill effect on bids is not enough to constitute cause under Section 363).

Practice Pointers for Practitioners Addressing Credit Bid Rights

1. Secured Creditors

a. A secured creditor considering a credit bid for the collateral assets should insist on providing any debtor-in-possession financing reasonably requested and/or needed to fund the debtor's operations while in bankruptcy. A priming lien will almost certainly serve to block any credit bid rights. Notwithstanding any leg up created for the secured lender in a

sale process, the provided financing presumably should operate to protect the assets by providing a funded Bankruptcy process. As a condition of any DIP financing, secured parties should insist that the debtor stipulate to (i) the collateral and validity and priority of the security; (ii) the amount of the claim; and (iii) the credit bid rights of the secured party.

b. Most secured creditors considering a loan to own opportunity will be (i) in contact with the target and (ii) on reasonably friendly terms with the Debtor. Accordingly, in advance of the bankruptcy filing, the secured party should take all steps necessary to confirm the debts owed to it and its security interests in all the assets it has as collateral. This should include an internal audit of secured positions and any remedial actions needed. Any doubt or challenge to the lien or the allowed claim will lead to scrutiny and delay.

c. Consider whether speed of sale is really a strategic advantage. Courts appear to be viewing sales under Section 363 through a speed lens, with expedited sales incurring higher scrutiny (requiring in some cases, extraordinary explanations as to why expedited speed is necessary). If speed is needed to preserve the business of the debtor, be certain to understand what the business reasons are for the speed required as opposed to creating a sale process full of possible bidders.

2. Debtors

a. When proposing a sale process, especially with a credit bidder likely to bid or serving as a stalking horse bidder, demand a process that allows the market to be tested and confirmed. A process designed to locate and secure the highest and best economic outcome is generally proof positive that value is being driven, regardless of any interested credit bidders.

b. Consider using credit bid rights as a carrot or consideration for a secured lender to support a Chapter 11 and Section 363 sale process.

c. If a debtor's senior secured creditor is not providing DIP financing or is a stalking horse bidder, consider the impact of seeking to limit or prohibit credit bidding as an effort to convince a lender to provide financing.

d. Speed and exclusivity in a sale process are understood, even for a debtor. However, a debtor must remember its duties and role. Even if the debtor prefers the credit bid, balancing the alternatives and promoting an open process designed to achieve asset maximization and no business interruption are critical.

3. **Committees**

a. Committees generally have concerns and approaches that overlap with the debtor (maximizing value, maintaining operations, and/or ensuring future flow of product or services). Accordingly, Committees are interested in achieving a closed sale and want to be certain to not jeopardize this result.

b. Notwithstanding the interest in a completed sale transaction, Committees also must consider whether greater value is achieved from a high credit bid (with certain close) or robust bidding (and possibly no credit bid). This decision is often a difficult choice therefore business and legal advisors are key to this evaluation.

c. A Committee may be in a position to use consent to the credit bid as a lever to obtain other consideration for its constituency. The recent case law on application of cause can, at least, give a secured creditor pause if it believes its credit bid (and ultimately its strategy to maximize value) could come under expensive scrutiny and possibly even challenge or curtailment. The rulings expanding "cause" are just another tool in the toolbox of any Committee professional.

Use of Examiners in Non-Individual Chapter 11 Cases

Best Practices: Use of Examiners in Non-Individual Chapter 11 Cases

Patricia B. Fugée, Esq.

I. Management of a Chapter 11 Debtor and Appointment of a Trustee

The general rule in chapter 11 proceedings, unlike chapters 7 and 13, is that there is no trustee appointed and instead, the debtor remains "in possession" of its business and operations. However, there are instances when it is appropriate to appoint a trustee to displace management and take over operations, or, in a less drastic form of relief, appoint an examiner to assess the debtor's operations and/or address particular concerns.

Accordingly, section 1104(a) provides that at any time after commencement of the case but before confirmation of a plan, on request of any party in interest or the United States Trustee and after notice and hearing, the Court *shall* order the appointment of a trustee under certain circumstances. This section sets forth that a trustee shall be appointed for cause, including fraud, dishonesty, incompetence or gross mismanagement of the affairs of the debtor. 11 U.S.C. § 1104(a)(1). It also provides for appointment of a trustee where doing so is "in the interests of creditors, any equity security holders, and other interests of the estate." 11 U.S.C. § 1104(a)(2).

Further, section 1104(e) provides that the United States Trustee *shall* move for the appointment of a trustee under section 1104(a) if there are reasonable grounds to suspect that the debtor's management or any one of its officers participate in actual fraud, dishonesty, or criminal conduct in the management of the debtor or the debtor's public financial reporting. Some of the interesting questions raised by this provision are the meaning of "reasonable grounds," and who will enforce it.

Appointment of a chapter 11 trustee is a drastic measure, because it completely removes the management of the debtor. A chapter 11 trustee's duties are set forth in section 1106(a), which provides:

> A trustee shall—
> **(1)** perform the duties of the trustee, as specified in paragraphs (2), (5), (7), (8), (9), (10), (11), and (12) of section 704 (a);
>
> **(2)** if the debtor has not done so, file the list, schedule, and statement required under section 521 (a)(1) of this title;
>
> **(3)** except to the extent that the court orders otherwise, investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such business, and any other matter relevant to the case or to the formulation of a plan;
>
> **(4)** as soon as practicable—
>
> > **(A)** file a statement of any investigation conducted under paragraph (3) of this subsection, including any fact ascertained pertaining to fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the affairs of the debtor, or to a cause of action available to the estate; and
> > **(B)** transmit a copy or a summary of any such statement to any creditors' committee or equity security holders' committee, to any indenture trustee, and to such other entity as the court designates;
>
> **(5)** as soon as practicable, file a plan under section 1121 of this title, file a report of why the trustee will not file a plan, or recommend conversion of the case to a case under chapter 7, 12, or 13 of this title or dismissal of the case;
>
> **(6)** for any year for which the debtor has not filed a tax return required by law, furnish, without personal liability, such information as may be required by the governmental unit with which such tax return was to be filed, in light of the condition of the debtor's books and records and the availability of such information;
>
> **(7)** after confirmation of a plan, file such reports as are necessary or as the court orders; and
>
> **(8)** if with respect to the debtor there is a claim for a domestic support obligation, provide the applicable notice specified in subsection (c).

Thus, a chapter 11 trustee completely replaces the prior management of a chapter 11 debtor. Given that chapter 11 trustees are eligible for percentage compensation under 11 U.S.C. § 326, appointment of a chapter 11 trustee can also be expensive, depending on the terms of the appointment and the debtor's operations.

II Examiners as an Alternative

Appointment of an examiner to investigate the affairs of the debtor can be a less drastic and less expensive alternative to the appointment of a trustee. Section 1104(c) provides that if the Court does not order the appointment of a trustee, then any time before confirmation, on request of a party or the U.S. Trustee, after notice and hearing, the court shall order the appointment of an examiner to conduct such an investigation of the debtor as is appropriate, including any allegation of fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the debtor's affairs, if (1) such appointment is in the interests of creditors and the estate, or (2) the debtor's unsecured debts, other than for goods, services or taxes, exceed $5.0 million. Although the language of the section is mandatory, most courts have found that the court retains discretion to direct the nature, extent and duration of the examiner's investigation. *See, e.g., In re Revco D.S., Inc.*, 898 F.2d 498 (6th Cir. 1990); *In re Bradlees Stores*, 209 B.R. 36 (Bankr S.D.N.Y. 1997).

Like trustees, an examiner needs to be a disinterested person. 11 U.S.C. § 1104(d). The duties of an examiner are set forth in section 1106(b):

> **(b)** An examiner appointed under section 1104 (d) of this title shall perform the duties specified in paragraphs (3) and (4) of subsection (a) of this section, and, except to the extent that the court orders otherwise, any other duties of the trustee that the court orders the debtor in possession not to perform.

The Code does not contain other requirements for who may be an examiner, therefore, the best person is determined on a case-by-case basis, which makes sense given that the specific duties of an examiner can vary from case to case.

Examiners are typically paid on an hourly basis by the bankruptcy estate, and need to file fee applications, like other professionals, pursuant to 11 U.S.C. § 330. In appropriate cases, examiners may also retain professionals, who would similarly be paid by the bankruptcy estate.

I was appointed as an examiner in a case, and I think it is a good example of how an examiner can address concerns without being overly disruptive of the case. In the chapter 11 case of *In re Triple Diamond Plastics*, case number 09-35938 pending in the Northern District of Ohio, Western Division, Bankruptcy Judge Mary Ann Whipple addressed the secured creditor's motion for the appointment of a trustee by entering an order for the appointment of an examiner instead. *See* docket no. 239, 240. That order directed the U.S. Trustee's office to file a motion for the appointment, which they did, and the Court approved my appointment. *See* docket no. 256, 269. Following an FBI background check, I was able to investigate the issues directed by Judge Whipple, and then I filed a report of my investigation. *See*, docket 321. After my report was completed, I filed a motion to be discharged in order to ensure that I had done what the Court requested, as well as a fee application, both of which were granted. *See* docket no. 335 (motion for discharge). In that case, I was appointed at a time when the debtor had been successfully operating in the case for a period of time, and plan confirmation proceedings had already begun. I believe that I was able to address the issues of concern raised by the creditor, and then the debtor was able to confirm its plan.

If you need additional information about examiners and more sample forms, I recommend the American Bankruptcy Institute publication "*The Bankruptcy Court's Watchdog: The Appointment, Role and Power of Examiners Today*" by John C. (Kit) Weitnauer.

Adversary Proceedings Outline

Best Practices
Non Individual/Business
Adversary Proceedings

I. COMMUNICATE WITH OPPOSING COUNSEL EARLY IN THE PROCESS

II. JURISDICTION CHALLENGES

A. Subject matter jurisdiction

1. 28 U.S.C. § 157(b)(1) states that 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. . . and may enter appropriate orders and judgments. Section 157(b)(2) provides a non-exhaustive list of core proceedings.

2. However, in Stern v. Marshal, the SCOTUS held that a bankruptcy court, because it is a non-Article III court, lacked authority under Article III of the United States Constitution to enter a final judgment on a state law compulsory counterclaim that is not resolved in the process of ruling on a creditor's proof of claim. This was despite Congress granting statutory authority under 28 U.S.C. § 157(b)(2).

B. Personal jurisdiction

1. For a bankruptcy court to exercise personal jurisdiction over a defendant, the plaintiff must demonstrate that the defendant has sufficient minimum contacts with the United States such that requiring the defendant to appear before the bankruptcy court would comport with the traditional notions of fair play and substantial justice.

2. General jurisdiction: exists where a party's contacts with a forum are substantial, continuous and systematic.

3. Specific jurisdiction: exists when a party's contacts with a forum are not "substantial, continuous and systematic," but the party has engaged in activities within the forum that give rise to, or are related to, the Plaintiff's claim.

III. SERVICE OF PROCESS

A. Rule 7004 - Adopts most of Rule 4 of the Federal Rules

1. Nationwide 1st class mail service

2. U.S./Agencies Service- Rule 7004(b)(4)

a) Attorney General

b) U.S. Attorney for District

c) Agency

d) Best practice: postage is cheap compared to additional time. If you are uncertain as to the specific agency address or department within that agency which needs to be served, send to all that you can find

3. Debtor Service

   a) Residence in petition/or as changed-

   b) Debtor's counsel

4. Insured Depository and Institution

   a) Certified mail, addressed to "Officer".

   b) https://research.fdic.gov/bankfind/ find out if institution is an Insured Depository Institution

   c) Best Practice: serve by certified and regular mail if there is any doubt.

5. Service upon corporation

   a) Address fist class mail to "officer or managing agent."

   b) Best practice: use due diligence to discover the name of an officer and serve that individual. If you are uncertain of the individual's name or afraid that you don't have the name of a current officer, serve upon "officer or managing agent" as an alternative. See In re Saucier, 366 B.R. 780, 784-85 (Bankr. N.D. Ohio 2007)

6. SUBSEQUENT PAPERS

   a) Serve counsel and any unrepresented parties

   b) Service of motions: comply with local rule 9013-1 and 9013-3.

7. Certificate of service requirements: Local Rule 9013-3:

   a) A certificate of service shall be appended to and served with any document tendered for filing which is required to be served (excepting any document required to be served together with a summons). The certificate of service shall be signed and shall:

      - Identify, with specificity, the document served;
      - State the date and method of service;
      - Identify, by name and address, each entity served; and
      - Contain or refer to an accompanying notice as required by LBR 9013-1(a).

   b) Parties in default need not be served

   c) Best practice: serve both the application for entry of default and motion and order for entry of default judgment be served on all parties

IV. CONTROL OF ATTORNEY-CLIENT PRIVILEGE

A. Explaining it to clients

1. The attorney-client privilege protects the confidentiality of communications between an attorney and the client made for the purpose of securing legal advice.

2. Any individual, entity, or government body that seeks the advice of an attorney and establishes an attorney-client relationship will be considered a client that has the right to assert privilege over its communications with his/its attorney(s).

B. Control of attorney-client privilege

1. It is well established that the attorney-client privilege is held and controlled by the client and not the attorney. Therefore, while the attorney-client privilege is most often asserted by the attorney on behalf of the client, ultimately it is the client, and not legal counsel, who may choose to assert the privilege or waive its protections.

2. The actor whose duties most closely resemble those of management should control the privilege within bankruptcy.

a) Therefore, in the typical corporate Chapter 11 bankruptcy proceeding, and in the absence of a bankruptcy trustee, the debtor in possession controls the corporation's attorney-client privilege.

b) Where a trustee, including a liquidation trustee, is appointed in a bankruptcy proceeding, the attorney-client privilege can be expected to pass to that individual, provided that he or she has been vested with control over the debtor's bankruptcy estate or the particular claims to which the privilege applies.

V. KNOW THE APPLICABLE RULES.

A. Fed. Bankr. R. 5005. Filing and Transmittal of Papers:

1. Filing.

a) Place of filing. The lists, schedules, statements, proofs of claim or interest, complaints, motions, applications, objections and other papers required to be filed by these rules, except as provided in 28 U.S.C. § 1409, shall be filed with the clerk in the district where the case under the Code is pending. The judge of that court may permit the papers to be filed with the judge, in which event the filing date shall be noted thereon, and they shall be forthwith transmitted to the clerk. The clerk shall not refuse to accept for filing any petition or other paper presented for the purpose of filing solely because it is not presented in proper form as required by these rules or any local rules or practices.

b) Filing by electronic means. A court may by local rule permit or require documents to be filed, signed, or verified by electronic means that are consistent with technical standards, if any, that the Judicial Conference of the United States establishes. A local rule may require filing by electronic means only if reasonable exceptions are allowed. A document filed by electronic means in compliance with a local rule constitutes a written paper for the purpose of applying these rules, the Federal Rules of Civil Procedure made applicable by these rules, and § 107 of the Code [11 USCS § 107].

2. Transmittal to the United States trustee.

a) The complaints, motions, applications, objections and other papers required to be transmitted to the United States trustee by these rules shall be mailed or delivered to an office of the United States trustee, or to another place designated by the United States trustee, in the district where the case under the Code is pending.

b) The entity, other than the clerk, transmitting a paper to the United States trustee shall promptly file as proof of such transmittal a verified statement identifying the paper and stating the date on which it was transmitted to the United States trustee.

c) Nothing in these rules shall require the clerk to transmit any paper to the United States trustee if the United States trustee requests in writing that the paper not be transmitted.

3. Error in filing or transmittal. A paper intended to be filed with the clerk but erroneously delivered to the United States trustee, the trustee, the attorney for the trustee, a bankruptcy judge, a district judge, the clerk of the bankruptcy appellate panel, or the clerk of the district court shall, after the date of its receipt has been noted thereon, be transmitted forthwith to the clerk of the bankruptcy court. A paper intended to be transmitted to the United States trustee but erroneously delivered to the clerk, the trustee, the attorney for the trustee, a bankruptcy judge, a district judge, the clerk of the bankruptcy appellate panel, or the clerk of the district court shall, after the date of its receipt has been noted thereon, be transmitted forthwith to the United States trustee. In the interest of justice, the court may order that a paper erroneously delivered shall be deemed filed with the clerk or transmitted to the United States trustee as of the date of its original delivery.

B. Local Bankruptcy Rule 5005-1

1. Form. Except as otherwise ordered by the Court, all documents presented for filing or lodging in paper format either by mail or over the counter:

a) Shall be printed, typewritten, or hand printed in ink on 8½ x 11 inch white paper. The Clerk may accept different sized documents, such as computer printouts.

b) Shall be prepared on only one side of the document. No duplex or double-sided printing will be accepted.

c) Shall not be pre-punched.

2. Facsimile Transmissions. The Clerk shall not accept for filing any facsimile transmission unless ordered by the Court.

3. Signatures. Signatures on the petition, pleadings, motions, and other documents submitted to the Court, either by conventional means or by electronic means established by the Court, shall include the attorney's typewritten name, firm affiliation, if any, address, telephone number, facsimile number, e-mail address, and Bar Registration Number. The signature of an attorney on any document filed by electronic means shall be indicated as "s/name."

Last Revised: May 16, 2011

C. Fed. Bankr. R. 9013. Motions: Form and Service

1. A request for an order, except when an application is authorized by the rules, shall be by written motion, unless made during a hearing. The motion shall state with particularity the grounds therefor, and shall set forth the relief or order sought. Every written motion, other than one which may be considered ex parte, shall be served by the moving party within the time determined under Rule 9006(d). The moving party shall serve the motion on:

   a) the trustee or debtor in possession and on those entities specified by these rules; or

   b) the entities the court directs if these rules do not require service or specify the entities to be served.

D. Local Bankruptcy Rule 9013-1

1. Certificate of Service and Notice. A motion or application tendered for filing shall be accompanied by (1) a certificate of service in accordance with LBR 9013-3 and (2) a notice to all persons entitled to notice that any objection must be filed within 14 days, or such other time as specified by applicable Federal Rule of Bankruptcy Procedure or statute or as the Court may order, from the date of service as set forth on the certificate of service, if the relief sought is opposed, and that the Court is authorized to grant the relief requested without further notice unless a timely objection is filed.

2. Response. Unless otherwise ordered by the Court, a response memorandum must be filed if the relief sought by a motion or application is opposed. The response shall specifically designate the motion or application to which it responds and, subject to Fed. R. Bankr. P. 9006(f), shall be filed within 14 days from the date of service as set forth on the certificate of service attached to the motion or application. The response shall state with particularity the reasons that the motion or application is opposed.

3. Reply. Subject to Fed. R. Bankr. P. 9006(f), a reply may be filed within 7 days after the date of service shown on the certificate of service of the response. No additional briefing will be considered except upon leave of Court for good cause shown.

4. Effect of No Response. Failure to file a response on a timely basis may be cause for the Court to grant the motion or application as filed without further notice to the extent such action would not conflict with any Federal Rule of Bankruptcy or Civil Procedure.

5. No Oral Arguments on Motions. Motions and applications shall be decided without oral argument unless otherwise provided in these rules or a hearing is scheduled by the Court.

Last Revised: May 16, 2011

E. Local Bankruptcy Rule 9013-2

1. Page Limitation. No motion or response thereto, including written argument and cited authorities, shall exceed 20 pages in length, exclusive of appendices, unless the party has first sought and obtained leave of Court. Font size, including footnotes, shall be at least 12 point. Where such leave is granted, a table of contents containing a summary of all points raised shall be included with the brief or memorandum.

2. Supporting Evidence. If a motion, opposition brief, or reply brief requires the consideration of facts not appearing of record, a party shall serve and file copies of all documentary evidence and photographs that it intends to rely upon in addition to the affidavits required or permitted by the Federal Rules of Bankruptcy Procedure. In those

instances where a party deems it necessary, or the Federal Rules of Bankruptcy Procedure otherwise require that evidence, by way of deposition, be submitted with and/or incorporated into a motion, only those pages of the deposition which contain the pertinent testimony shall be attached to the motion. The party shall not file the entire deposition in support of the motion, as long as certain pages or portions thereof will suffice to establish the party's position.

3. Citations of Statutes and Regulations. All motions and briefs containing references to statutes or regulations shall cite the United States Code or the Code of Federal Regulations, or have attached thereto a copy of the statute or regulation.

4. Unreported Opinions. If an unreported opinion or an opinion available only through an electronic retrieval process is cited, a copy of the opinion shall be attached to the brief or memorandum, and such attachment shall be an exception to the 20 page limitation in (a) above.

5. Compliance. Failure to comply with any of the requirements of this Rule may be grounds for striking the motion or brief.

Last Revised: May 16, 2011

F. Local Bankruptcy Rule 9013-3

1. A certificate of service shall be appended to and served with any document tendered for filing which is required to be served (excepting any document required to be served together with a summons). The certificate of service shall be signed and shall:

a) Identify, with specificity, the document served;

b) State the date and method of service;

c) Identify, by name and address, each entity served; and

d) Contain or refer to an accompanying notice as required by LBR 9013-1(a).

Last Revised: May 16, 2011

VI. REVIEW PLEADINGS AND ORDER IN CASE

A. Case Management Orders

1. Court dates

a) Check judicial posting on website to see if new or updated standing orders or memoranda regarding Adversary procedures have been posted.

b) Failure to comply with the Court's pretrial order could result in sanctions, including dismissal of your case. In re McDowell, 163 B.R. 509, 512 (Bankr. N.D. Ohio 1994)

2. Discovery dates:

a) Plan ahead. A Court may not be inclined to grant a discovery extension if, for example, you wait until the week before the deadline to attempt scheduling a deposition.

3. Reservation of authority for filing of dispositive motions

4. Reminder of efforts to be undertaken before motion practice

5. Suggestion of communication with and civility toward opposing counsel. See In re Mann, 220 B.R. 351 (Bankr. N.D. Ohio 1998)

B. Trial Orders

1. Witness/Exhibit lists

2. Findings of fact/Conclusions of law

3. Briefs

C. Exhibits - Local Rule 9070 deals with exhibits:

1. Binder/Index/Mark with numbers if plaintiff/letters if defendant

a) Multi page exhibits must be numbered

2. Best practice: Place in binder in anticipated order with tabs marking each exhibit. This helps the court follow your case and is useful for your witnesses.

D. Review of pleadings

1. Must know what claim is and what disputed allegations exist/affirmative defenses.

a) This will help you form your discovery plan and the time needed to complete it.

2. Check during case

a) Sometimes claim may take different direction

b) Amend as necessary and as promptly as possible

E. Appeal - Rule 8001; 8002

1. Timely filing of appeal - 14 days unless extended

2. Any other failure does not affect validity of appeal. The only critical error is not filing your notice of appeal.

3. Certain motions will extend the time for filing an appeal: (1) a motion to amend of make additional findings of fact, (2) motion to alter or amend judgment, (3) motion for a new trial, (4) motion for relief from judgment.. FRBP 8002(b).

a) A notice of appeal filed before the resolution of any of the Rule 8002(b) motions will not be effective to appeal that motion. A notice, or amended notice of appeal must be filed with 14 days of the order disposing of the motion of a type list in FRBP 8002(b) in order to appeal that ruling.

4. Best practice: Unless you are frequently appealing decisions, read rules on appeal each time an appeal is contemplated. Missing a deadline to appeal makes for an easy malpractice action. If your client is unsure and the deadline is approaching, prepare the notice of appeal. The document is easy to prepare and it will be ready in case there is a last minute decision to file.

VII. AUTOMATIC REFERRAL AND WITHDRAWAL OF REFERENCE

A. The Bankruptcy Amendments and Federal Judgeship Act of 1984 vested the district courts with original jurisdiction over all cases arising under Title 11 of the Bankruptcy Code. Pursuant to 28 U.S.C. § 157, a district court may provide that cases under Title 11, proceedings under Title 11, and proceedings related to a case under Title 11 shall be referred to the bankruptcy judges for that district.

B. 28 U.S.C. §157(d) provides that "[t]he district court may withdraw, in whole or in part, any case or proceeding referred under this section on its own motion or on timely motion of any party for cause shown."

C. Rule 5011(a) of the Federal Rules of Bankruptcy Procedure provides that, "[a] motion for withdrawal of a case or proceeding shall be heard by a district judge."

D. In most Districts, the motion to withdraw reference is filed with the bankruptcy court and then transferred to the District Court for determination

VIII. LITIGATION HOLDS

A. Identifying Contents of/Procedures for Hold

1. Understand Client's Document Retention Policies

a) How/where are documents maintained (electronic and paper);

- Types of Documents: email, presentations, spreadsheets, databases, calendar appointments, paper files, notes, pictures, videos, data logs, etc.
- Office locations: servers, laptops, desktops;
- Mobile devices: phones, tablets; and
- Home access: remote access.

b) When are documents destroyed?

c) Are back-ups maintained?

d) How difficult/costly is recovery from back-up source?

e) Who has Responsibility Over Documents?

- IT Department Controls;
- Manager Access.

2. Identify Sources of Documents.

3. Identify Types of Documents to Preserve.

B. Consequences of Failing to Hold

1. Adverse Inferences

2. Monetary Sanctions

IX. SETTLEMENT ANALYSIS

A. Know deadline for claims

B. Know amount and nature of claims filed

C. Avoidance actions

1. Know change in claims pool which will potentially result if transfer is avoided

2. Unsecured claim arising from avoided transfer can be filed 30 days after judgment becomes final - Rule 3002(c)(3)

D. Best practice: communicate frequently with your client. Make sure your client has reasonable expectations regarding the range of potential settlement options.