Chapter 7 Track

Commercial: Going Gently into That Good Night: The Process of Converting Cases to Chapter 7

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AMERICAN BANKRUPTCY INSTITUTE
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GOING GENTLY INTO THAT GOOD NIGHT: THE PROCESS OF CONVERTING CASES TO CHAPTER 7

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DISCUSSION OUTLINE: THE CONVERSION PROCESS FROM THE PERSPECTIVE OF EACH CONSTITUENCY

A. Debtor.
1. Common scenarios warranting conversion of chapter 11 reorganization case to chapter 7 liquidation case from the business debtor's perspective:
    a. Administrative insolvency (inability to pay postpetition debts as they are incurred).
    b. Failure of sale process.
    c. Consummated chapter 11 going concern sale or liquidation, but estate lacking sufficient resources to confirm a plan.
    d. Management corruption and/or incompetence.
    e. The "rudderless" debtor (i.e., management resigns).
    f. Inability to consummate confirmed plan.
2. Key issues for Debtor:
    a. Making sure employees receive earned compensation (both "right thing to do" and limits responsible person liability of managers).
    b. Preservation of insurance (both part of DIP duties and sensible for Debtor's managers).
    c. Securing Debtor's premises and other assets until trustee can take possession.
    d. Communicating any issues to the trustee that may impact health, safety or welfare (e.g., potential for environmental pollution discharge).
    e. Making filings required by F. R. Bankr. P. 1019, including schedule of unpaid postpetition debts.
    f. Ensuring someone available to communicate on behalf of the debtor with the trustee.
    g. Preservation of books and records.
    h. Potential that trustee may pursue litigation against directors and officers.

B. Prepetition Lender/DIP Lender.
1. Common scenarios warranting conversion from the perspective of the prepetition secured lender / DIP lender:
    a. Failure of going concern sale process to generate sufficient value.
    b. Unacceptably high chapter 11 administrative expenses.
    c. Unanticipated decline in value of, or loss of, collateral.
    d. Loss in confidence of debtor's managers.

e. Unwieldy capital structure / Intercreditor dysfunctionality (e.g., other nonconsenting lenders and inability to prime).
f. Hostile / uncooperative debtor or committee (e.g., pursuing challenges to lenders' liens and claims).

2. Key Issues for Prepetition Lender / DIP Lender:
   a. Avoiding additional liability.
      i. Release and waivers -- 506(c), 552(b);
      ii. Interim vs. Final Approval of DIP Financing.
      iii. Potential WARN Act liability.
      iv. Potential "responsible person" liability under wage statutes, tax laws, environmental laws, etc.
      v. Potential lender liability claims (e.g., if deemed nonstatutory insider).
      vi. Potential that trustee will pursue claims or causes of action against lender.
   b. Maximizing its distribution.
      i. Whether to seek relief from stay upon conversion to recover its collateral.
      ii. Logistics of protect and getting access to its collateral.
      iii. Obtaining cooperation of chapter 7 trustee.
      iv. Negotiating carve-out with chapter 7 trustee to monetize collateral.
      v. Advancing the resolution of the chapter 7 case.

C. Unsecured Creditors.

1. Common scenarios warranting conversion from perspective of unsecured creditors:
   a. Perception of waste of corporate assets / excessive costs of administration in chapter 11.
   b. Out of the money in chapter 11 case – perception that unsecured creditors may do better if liquidation and chapter 7 trustee pursues avoidance actions.
2. Key Issues for unsecured creditors:
   a. Timely assertion of claim(s):
      i. "An unsecured creditor or an equity security holder must file a proof of clam or interest for the claim or interest to be allowed…." Rule 3002(a).
      ii. "In a chapter 7 liquidation, … a proof of claim is timely filed if it is filed not later than 90 days after the first date

set for the meeting of creditors called under § 341(a)…."
Rule 3002(c)

1. What if your claim is included in Debtor's Schedules?
    - "The schedule of liabilities filed pursuant to § 521(1) of the Code shall constitute prima facie evidence of the validity an amount of the claims … unless they are scheduled as disputed, contingent, or unliquidated. It shall not be necessary for a creditor or equity security holder to file a proof of claim or interest except as provided in subdivision (c)(2) of this rule."" Rule 3003(b)(1) [applies only in Chapter 9 and 11 cases (see Rule 3003(a))]
2. What if you already file a POC in the Chapter 11 Case?
    - "All claims actually *filed by a creditor* before conversion of the case are deemed filed in the chapter 7 case." Rule 1019(3).
    - What about claims filed by a debtor (Rule 3004), codebtor (Rule 3005) or indenture trustee (Rule 3003(c)(1)) on behalf of the creditor?

b. Making sure the "right person" is in control of the estate.
   i. Possible trustee election.
      1. Why would creditors want to elect a Chapter 7 Trustee?
         a. Control over the Chapter 7 process. § 704(a)
            i. Whether Chapter 5 causes of action will be pursued? § 704(a)(2).
            ii. Control of Debtor's attorney-client privilege.
         b. Accountability [§ 704(a)(2)] and visibility [§ 702(a)(7)] during the Chapter 7 process.
         c. Concerns regarding Trustee compensation. § 326(a).
         d. Specific knowledge necessary to maximize return to creditors.
   ii. Trustee Elections -- § 702.

1. Who is eligible to vote? "A creditor may vote … only if such creditor –
    a. Holds an allowable, undisputed, fixed, liquidated, unsecured claim of a kind entitled to distribution under section 726(a)(2), 726(a)(3), 726(a)(4), 752(a), 766(h) or 766(i)…";
        i. What is "allowable"?
        ii. Is a filed POC required? § 702 v. Rule 2003.
    b. Does not have an interest materially adverse … to the interest of creditors entitled to such distribution; and
        i. What is a "materially adverse interest"?
    c. Is not an insider." §702(a).
2. How is a Trustee elected?
    a. At the § 341 meeting, eligible creditors holding at least 20 percent in amount of the claims specified in subsection (a)(1) vote; and
    b. Such candidate receives votes of creditors holding a majority in amount of claims specified in subsection (a)(1) that are held by creditors that vote for a trustee.
    c. If no trustee is elected, the interim trustee becomes the trustee. §702(d).
3. Proxies and limited solicitation are permitted. Rule 2006.
4. Disputed elections. Rule 2003(d).
5. One or more trustees may be elected. Rule 2009.

D. U.S. Trustee.
1. *Perspective*: the Watchdog.
2. *Perception*: the Watchdog.
3. Focused on:
    a. Need to get trustee appointed and in place quickly (diminution of asset value; safety and welfare of public).
    b. Pre-appointment identification of interim Chapter 7 Trustee.
    c. Need to make sure assets are secure in connection with conversion.

E. Newly Appointed Interim Chapter 7 Trustee.
   1. *Perspective*: Just had a mess dumped in his lap and is looking for cooperation from Debtor's counsel and Debtor's management.
   2. *Perception*: the "undertaker"
   3. Focused on:
      a. Delaware Panel of Trustees' list of documents/disclosures to facilitate administration of converted cases;
      b. Obligation/willingness to act during interim period.
      c. Financing for administration of Chapter 7.
   4. Retention of former management on "consultant" basis.

Panel Hypothetical: The Apocalypse of the Zombie Debtors

The Debtors' Business

Zombie Apocalypse Personal Safety ("ZAPS") was a developer and retailer of personal self-defense products for the ongoing zombie apocalypse (yes, folks, it's here). ZAPs also had entered the toy market with a line of "Zombie Apocalypse" themed toys and video games under the ZAPS Kids® trade name.

ZAPS was the brain child (or as he likes to say it, the "brains eating child") of Max A.B. Romero ("Romero"). Prior to founding ZAPS, Romero had spectacular timing with his start-up Zombie Free Home, Inc. ("ZF Home"), which developed and marketed a line of Zombie-readiness home improvement products. ZF Home's products, including non-scalable aluminum siding and zombie-proof fences, entered the market just as the zombie apocalypse was getting underway. In early 2017, Romero sold ZF Home to the privately-held Umbrella Capital Partners, Inc. ("Umbrella Capital") for an undisclosed sum. Romero then immediately began re-investing his personal fortune in ZAPS. By the end of 2023, it is estimated that Romero had poured more than $85 million of his own money into ZAPS.

Romero envisioned ZAPS as a one-stop shopping site for all things you could ever need to fend off the Zombie Apocalypse. Bite proof, Kevlar jumpsuits? They got em. Self-sharpening katana swords? They got em. Zombie "lobo" skull mashers? They got em. Zombie survival kits? They got em. And so on.

ZAPS' corporate headquarters was located outside of Atlanta, Georgia, from which location it also operated its internet retailing operations. ZAPS occupied its corporate headquarter under a real property lease (the "Headquarters Lease") with an initial five year term that was to expire on September 30, 2024, plus a three year option. Under the Headquarters Lease, in order to exercise the option, the tenant (i) must not be in default, (ii) must pay a $50,000 option fee, and (iii) must give irrevocable notice of its intent to exercise the option at least 90 days before the expiration of the initial term.

Additionally, ZAPS maintained a state of the art research and development facility (the "R&D Facility") located in Badger City, Pennsylvania, a rural area approximately 30 miles north of Pittsburgh. ZAPS owned the R&D Facility and the surrounding 48 acres of largely wooded land outright. The R&D Facility, which ZAPS employees had dubbed the "Hive," was a secure underground structure that ZAPS had specially constructed to meet is R&D needs. By the end of 2023, ZAPS held 13 issued patents and 4 patent applications for zombie self-defense products, including 3 patents that were integral to its Zombie Off! zombie repellant spray. Fanatical about security, Romero had installed two layers of 14 foot high electrified fencing with HD and cameras around the property and had contracted with a high end security and zombie defense service (the only one serving that remote region of Pennsylvania).

Next, ZAPS operated 4 (of a total of 12 planned) regional ZAPS Supercenter® stores. The Supercenters occupied big box freestanding stores in shopping centers located near: Atlanta, Georgia; Philadelphia, Pennsylvania; Chicago, Illinois; and San Francisco, California. All four of its retail locations were leased.

Finally, ZAPS operated a 400,000 square foot state of the art fulfillment center near Middletown, Delaware. This facility was special purpose built for ZAPS in 2022 and ZAPS

occupied it under a 20 year lease. ZAPS was lured to Delaware by a $2,000,000 development grant and $10,000,000 subsidized unsecured loan.

Corporate Organization

ZAPS Holdings Inc. ("Holdings"), a Delaware corporation, was the ultimate parent of the ZAPS family of affiliated companies. It had three direct subsidiaries: (i) ZAPS Operating LLC ("Operating"), a Delaware LLC that operated the bulk of ZAPS' retail businesses, including the ZAPS Supercenters and the ZAPS Kids toy line; (ii) ZAPS Fulfillment LLC ("Fulfillment"), also a Delaware LLC, that operated ZAPS' order fulfillment functions; and (iii) ZAPS Development LLC ("Development"), a Delaware LLC, that operated the R&D Facility and held most of ZAPS' intellectual property, including the patents and patent applications relating to the Zombie Off! product.

Capital Structure

Romero initially funded ZAPS from his personal fortune amassed from the sale of ZF Home in 2017. By June 2019, despite Romero having sunk in excess of $65 million of his own funds into the business, the R&D Facility was not yet complete and only 2 of the 12 planned ZAPS Supercenters were open. And, ZAPS had not yet brought to market what was to be its flagship product, "Zombie Off!," a new generation of zombie repellant.

In mid-2020, Romero approached his former partner Umbrella Capital for funding. In November 2020, Umbrella Capital purchased a 40% stake in Holdings in exchange for $35 million and a seat on Holdings' board of directors. Romero retained his seat on the board. The third and final seat was occupied by Dr. Richard Grimes ("Grimes"), a noted academic and ethno-biologist who acted as a compensated technical consultant to ZAPS, but had not ownership stake in the business and no prior experience as a director of a for-profit enterprise.

By September 2021, although the R&D Facility had been completed and the third and fourth ZAPS Supercenters were open, the company was again experiencing liquidity problems and the Zombie Off! product still had not been brought to market. With support from Romero and Umbrella Capital, ZAPS obtained a secured credit facility (the "ABL Facility") from Crypto National Bank ("CNB"), as agent and certain lenders thereunder (collectively, the "ABL Lenders"). The ABL Facility included a revolver with up to $20 million of availability and a $40 million term loan. Holdings was the borrower under the ABL Facility and Operations, Fulfillment, Intermediate and Development each guaranteed the obligations under the ABL Facility. CNB secured the obligations under the ABL Facility with a first lien on all of the assets of Holdings, Operations and Fulfillment, and the assets of Development other than its IP assets.

Short on cash again by June 2022, ZAPS returned to the capital markets. Holdings issued $55 million of high yield secured notes, due June 30, 2027 (the "Notes"), which were guaranteed by Operations, Fulfillment and Intermediate. The Note obligations were secured by a junior lien on substantially the same pool of assets as the ABL Facility.

By May 2023, Zombie Off! was in its final stages of testing with the product launch now set for November 2023 (in time for the Christmas season). But yet again, ZAPS was facing liquidity challenges and was approximately six weeks away from being unable to make payroll.

With time running short, Umbrella Capital agreed to provide the company with $10 million of additional funding pursuant to a bridge facility (the "Bridge Facility") secured by a first lien on the IP held by Development.

In November 2023, ZAPS finally released Zombie Off! to great fanfare. Sales were initially brisk, but dropped off sharply within two-three months. Focus group testing determined that the consumer sentiment was that Zombie Off! left the wearer smelling as if she had rolled around in a tub of old tuna fish salad and moldy rose petals. Moreover, while somewhat effective as a zombie repellant, it also had the unwanted effect of being a feline aphrodisiac. ZAPS' marketing team was publicly humiliated when a video went viral on the internet of an interview with a teenage girl who said of the product: "Well, like, I suppose it's better than having my brains eaten by an icky zombie, but does anyone know how to stop Fluffy from humping my leg?"

ZAPS lurched along for the next several months. During this period, a value investor, Body Parts Opportunities Fund XIII, L.P. ("BPOF"), began acquiring the Notes at a rumored 20-30% of par value. By May 2014, BPOF held substantially all of the outstanding Notes.

On May 9, 2024, BPOF, now holding the requisite amount of the Notes, directed the indenture trustee to call a default for violation of an EBITDA covenant under the Note indenture. Forty-eight hours later, CNB followed suit under the ABL Facility and swept all but $1,900,000 cash from the company's accounts.

Thereafter, Umbrella Capital disclosed to Romero and the other members of the board that it has agreed to partner with BPOF on a proposed acquisition of the company through a newly created entity, Not an Evil Plot to Take Over the World, LLC ("NEPTOW"), in which BPOF held a 70% interest and Umbrella Capital held a 30% interest. Through NEPTOW, they propose to acquire substantially all of ZAPS' assets free and clear of liens, claims and interests in a bankruptcy sale pursuant to section 363 of the Bankruptcy Code. The purchase consideration was to be:

(i) $25 million cash to be applied against the ABL Facility;

(ii) NEPTOW's assumption of the balance of the ABL Facility obligations (approximately another $22 million);

(iii) Credit bid as follows: (a) $10 million of Bridge Facility Obligations; (b) $27.5 million of senior secured supepriority DIP financing to be extended in chapter 11 cases filed by ZAPS (of which $7.5 million would be new money); and (c) $15 million of Note obligations; and

(iv) NEPTOW's assumption of the liabilities of certain trade creditors (on a list as yet to be provided) upon closing of the sale.

Upon hearing this proposal and feeling betrayed by his longtime backer Umbrella Capital, Romero stomped out of the boardroom muttering something about zombies being a higher life form than vultures. Dr. Grimes, the sole-remaining arguably disinterested board member agreed to act as a special committee of one in connection with the transaction, something he has never done before. Somewhat at a loss, Dr. Grimes turned to his brother-in-law Shaun Ubdaded for advice and engaged his law firm, Blood, Sweat and Innards, PC ("BSI"), as restructuring and, if necessary, general bankruptcy counsel for the company. Ubdaded's focus was creditors' rights. He had not had a debtor-side large business bankruptcy representation in

the last ten years, but a newly arrived lateral associate at BSI had worked on a debtor representation three years prior at his prior firm. BSI received an initial retainer of $250,000.

Promptly thereafter, Ubdaded recommended that ZAPS engage Dennis Alan ("Alan") of Rainbow Serpent Turnaround Solutions as its chief restructuring officer ("CRO"). Although Romero remained missing in action, ZAPS, through Grimes, acted on this recommendation and Alan was appointed CRO, reporting directly to Grimes. Alan agreed to a monthly flat fee of $25,000, with the possibility of a back-end transaction fee of $350,000 upon consummation of the NEPTOW sale or another transaction of equal or greater value. Although Alan's engagement agreement did not require ZAPS to pay him a retainer, after Alan commences the engagement, he gained a better appreciation of the company's dire liquidity situation and pre-paid himself $75,000 for the first three months of his engagement.

Days later, ZAPS engaged Bare Bones Capital Services ("BBCS"), which happened to be Alan's former firm, as its investment banker. BBCC's engagement agreement provided for it to be paid an advance of $500,000, of which $250,000 was deemed earned upon receipt. ZAPS wired the $500,000 hours after the engagement letter is signed. Under its engagement letter, BBCS would be entitled to a transaction fee of at least $1 million if the NEPTOW sale or another sale for greater value was consummated.

ZAPS also engaged the storied Delaware law firm Tallahassee, Columbus and Wichita LLP ("TCW") as its Delaware co-counsel. The noted Delaware bankruptcy attorney Harrelson Tallahassee ("Tallahassee") was to lead the engagement for TCW. ZAPS executed an engagement letter providing, among other things, that TCW was being engaged as Delaware co-counsel with BSI and that BSI would have primary responsibility for preparing and prosecuting any bankruptcy cases for the ZAPS entities. TCW received a retainer of just $25,000.

Initially, Ubdaded and BSI were determined to keep as much work in their firm as they could, consulting with TCW only occasionally to request a Delaware "form" that they use to prep first day motions for the cases. But, Ubdaded and BSI soon found that their four person bankruptcy department was totally overwhelmed by the demands of negotiating sale and financing transaction documents with NEPTOW's hoard of lawyers, overseeing the marketing and sale process, preparing the first day papers and other responsibilities. Approximately, 9 days before ZAPS was predicted to run out of cash, Ubdaded asked Harrelson and TCW to take over preparation of the first day papers and the negotiation and drafting of the DIP financing documents, which were then still in woefully bad shape. Harrelson and TCW stepped into the breach and got things squared away, but only after a herculean effort. By Friday, June 6, 2024, TCW's $25,000 retainer was fully exhausted and TCW was owed approximately $73,000 for fees and expenses. Later that same day, ZAPS wired $45,000 to TCW, which was all of the cash Alan determined ZAPS could spare and still make it through the weekend and beginning of the following week.

Meanwhile, on June 2, 2024, BBCS updated the board on the progress of its marketing efforts. BBCS told the board that it had quickly attempted to contact those strategic and financial buyers it could identify. But, by the time of its engagement, ZAPS had only four weeks of cash remaining at its then current burn rate. BBCS reported that 9 parties had executed confidentiality agreements and gained access to the data room (some of which was still being populated), but no party contacted had delivered a letter of intent or made any other serious expression of interest.

Left with no other viable options and without time or money available to conduct a more robust marketing process, on Friday, June 6, 2024, the board (minus Romero) authorized the ZAPS entities to file chapter 11 bankruptcy petitions in the United States Bankruptcy Court for the District of Delaware.

Post-Filing Bankruptcy Case History

One June 8, 2024, Holdings, Operations, Fulfillment and Development (collectively, the "Debtors") each filed voluntary chapter 11 bankruptcy petitions in the United States Bankruptcy Court for the District of Delaware. Minutes later, with board approval (again minus Romero), Alan signed the purchase agreement with NEPTOW and a sale motion was filed, together with a DIP financing motion and other typical first day requests for relief.

On June 10, 2024, the Bankruptcy Court convened a first day hearing. At the outset of the first day hearing, the Bankruptcy Judge noted that given the size and complexity of the case, he was requiring the parties to engage a fee examiner. In general, things went smoothly until the DIP financing motion was heard.

The proposed DIP facility consisted of a partial roll-up of the Note obligations ($10 million per the interim order and $20 million in the aggregate on a final basis) and $7.5 million of new money ($2.5 million of which would be authorized in the interim order). Pursuant to the proposed interim DIP financing order, NEPTOW would obtain an all asset lien (to be extended to Chapter 5 actions and their proceeds in the final order). The interim DIP financing order further provided for a carve-out covering (in addition to U.S. Trustee fees) incurred and approved fees of estate professionals to the extent provided for in the budget. The 13 week budget, in turn, included a line item for Debtors' professionals aggregating $850,000, and a separate line item for the Committee's professionals aggregating $75,000.

The proposed interim DIP financing order and financing documents also included events of default that would be triggered by the Debtors' failure to achieve certain milestones. One of these milestones required the entry of a bid procedures order within the first 5 days after the petitions were filed. At the first day hearing (after listing to a forceful and eloquent objection from the U.S. Trustee trial attorney assigned to the case), the Bankruptcy Judge informed the parties that he was unwilling to grant that relief on such an expedited timeframe. The parties requested an adjournment for 45 minutes.

When they returned 3 hours and 18 minutes later, the parties announced that NEPTOW had agreed to provide limited DIP financing on an interim basis, reducing its new money commitment in the interim DIP financing order by $500,000. As a consequence of this change, the Debtors reduced, on an interim basis, the total dollar amount of critical vendor payments they had requested in their critical vendor motion from $1 million to $500,000. Certain critical vendors, such as the security force for the R&D Facility, were dropped entirely from the list. The bid procedures and final DIP financings hearing were then scheduled for June 27, 2024, at 2:00 p.m., with objections due for the Committee at 12:00 noon on June 25, 2024.

One June 23, 2024, the U.S. Trustee formed an official committee of unsecured creditors (the "Committee"), comprised of: (a) the trade vendor who was ZAPS's primary supplier of blades for the zombie skullmashers and who was owed $1.3 million by Fulfillment; (b) the landlord for the Philadelphia based ZAPS Supercenter, who was party to a lease with Operations;

(c) the national and local chapter of the Zombie Defense Workers Labor Cooperative, representing the unionized employees at ZAPS' Middletown, Delaware warehouse facility who were party to a CBA with Fulfillment; (d) the plaintiff in a lawsuit against several of the Debtors and Romero, in which he alleged they were liable for the alienation of affections of his former spouse;[1] and (e) a former employee of Development, Peyton Wells, by then a plaintiff in whistleblower lawsuit, who had worked at the Hive until he was fired for talking to the press about the supposedly dangerous experiments being undertaken there.[2] The same day the Committee hired counsel Gray & Matters LLP, with named partner Matheson Gray leading the engagement. Financial advisors waited around all day, but at 4:00 p.m. were asked to provide telephonic pitches to the Committee the following day. Thereafter, the Committee selected Solomon Grundy & Partners as its financial advisor.

Committee counsel immediately requested an adjournment of the upcoming hearing, but NEPTOW refused. On June 25th, the Committee filed its objections to the bidding procedures and to the final DIP financing. Other objections included an objection from Romero (not heard from since before the bankruptcy filing). Romero's objection asserted that he was the owner of the three issued patents critical to the Zombie Off! active ingredient, which he contended were transferred to him by Development in May 2019 when he had infused his last $10 million into the company. Romero asserted further that he simultaneously granted Development a limited license to use the technology solely for the production of zombie repellant sprays within the United States for a period of 5 years. His objection attached an undated license agreement signed by Romero, both for himself and Development.

Absent a successful lien challenge or a wildly successful auction process, unsecured creditors were far out of the money. Nevertheless, after the objections of the Committee and Romero were filed, NEPTOW and the Debtors agreed to adjourn the hearings to the following Monday, June 30, 2024. Over the weekend, the Committee, the Debtors and NEPTOW negotiated an agreement in principle resolving the Committee's objections to the bidding procedures and the DIP financing. At the June 30th hearing, they announced the basic terms of the agreement on the record, which included: (i) the Committee's waiver of any causes of action against NEPTOW, BPOF and Umbrella Capital and their representatives, and of any challenge rights on behalf of the Debtors' estates to their liens and claims; (ii) the withdrawal of the Committee's objections to the bidding procedures and DIP financing; (iii) the agreement that avoidance actions (other than as to certain vendors identified by NEPTOW) would be retained by the Debtors' estates and the net proceeds thereof shared 50% by the Debtors' estates and 50% by NEPTOW; (iv) $500,000 that would be funded immediately and set aside as a trust for the benefit of general unsecured creditors, whether or not NEPTOW prevailed as the successful bidder and closed; (iv) $1 million cash that would be added to the purchase price and escrowed from the sale proceeds to wind down the estates and in contemplation of confirming a liquidating chapter 11 plan; and (vii) the agreement of NEPTOW, BPOF and Umbrella Capital to subordinate their deficiency claims if NEPTOW was the successful bidder. The bidding

[1] The man apparently slathered himself in Zombie Off! after his wife was bitten on her pinky toe by a zombie. She then ran off (or more accurately, "shuffled off") with his former best friend and next door neighbor, who had already been zombified (and was the one who bit her).

[2] There would have been 7 Committee members but two creditor representatives were eaten by zombies on their way to the organizational meeting.

procedures were approved and a further interim DIP financing order was entered to preserve the status quo. Everyone committed to document the settlement and present it with the final DIP financing order at the next hearing on July 11th. Romero's objection was overruled without prejudice to his ability to reassert it at the sale hearing or final DIP financing hearing. Late on June 30th, $500,000 was wired by NEPTOW to the trust account of Committee counsel.

Committee counsel Matheson Gray, left for the holiday weekend feeling pretty good about himself. The anticipated pool of general unsecured creditors was in the range of $17-20 million and they would now have a chance at a meaningful return.

The bid deadline passed on July 8, 2024. To no one's surprise, no competing bids were received. Indeed, for the last several months, the Center for Disease Control ("CDC") had again begun issuing press releases touting their progress on a zombie vaccine. The CDC had done this several times before. It was accepted wisdom that the press releases were more to calm everyone's nerves, than because of any expectation that a working vaccine was imminent. Nevertheless, this chatter had helped to depress interest in ZAPS' assets.

The auction, originally scheduled for 10:00 a.m. ET on Thursday, July 10, 2024, was canceled. However, at 7:34 a.m. on Thursday, to everyone's shock and dismay (proving how skewed the incentives can sometimes be in the restructuring world), the CDC announced that not only had they created a working vaccine that was 98% effective, but that in at least 50% of the cases it worked as a cure for those already infected.[3] Upon getting this news, NEPTOW immediately noticed MAC defaults under the DIP facility and its purchase agreement.

On July 11th, everyone returned to Bankruptcy Court. NEPTOW claimed that its settlement in principle with the Debtors and the Committee was no longer effective. NEPTOW also asked the Bankruptcy Court to confirm that it had no further obligations under the purchase agreement and that it could begin exercising remedies under the DIP facility. These positions were opposed by the Committee. After letting everyone vent, the judge sent them away and rescheduled the hearing for Tuesday, July 15th, which was within the 7 day period before NEPTOW could exercise remedies under the DIP facility.

By the time the parties returned the following Tuesday, cooler heads had prevailed. Everyone agreed that a going concern sale was now hopeless. NEPTOW was unwilling to fund more than what it had to under the carve-out, plus the bare minimum necessary to avoid total chaos until the cases could be converted to chapter 7 liquidation cases. Facing these realities, the parties had negotiated a "structured conversion" of the cases. In addition to providing for the conversion of the cases effective immediately, other terms of the proposed order included the following:

- Language confirming that NEPTOW had no further funding obligations under the DIP facility and giving NEPTOW the benefit of a section 506(c) waiver for the duration of the bankruptcy cases.
- Language exculpating the Debtors' officers and directors, the Committee and its members, NEPTOW, BPOF and Umbrella Capital from any liability in connection

[3] Grandma might forever after be a little smelly and have an unusual taste for raw calves' brains, but she would no longer be a zombie.

with the bankruptcy cases other than that resulting from their gross negligence or willful misconduct.

- A schedule of the professional fees that (following Court approval) would be paid out of the Carve-Out. Unfortunately, the scheduled omitted the Debtors' IP counsel who had been retained under section 327(e) and was owed approximately $60,000 for postpetition work. The fee examiner was also excluded from the schedule, despite the fact that he had incurred approximately $10,000 of fees getting up to speed and final fee applications were still to be filed.
- A date 30 days hence was set aside for final fee applications to be filed, with a hearing to be scheduled 30 days thereafter.
- $50,000 was set aside for the chapter 7 trustee, but subject to the limitation that it could not be used to investigate or prosecute claims or challenges with respect to NEPTOW, BPOF or Umbrella Capital.
- $300,000 would be funded into a trust by NEPTOW with the intention that the trust would be administered by the chapter 7 trustee for the benefit of general unsecured creditors (i.e., it would skip priority claimants).

Post-Conversion Events

An Order converting the cases to chapter 7 liquidations was entered and effective immediately as of the following day, July 16, 2024. Alice Milla was appointed as the interim chapter 7 trustee for the Debtors' estates (the "Trustee").

Consider the following additional facts that may impact how the post-conversion course of these cases:

- Prior to the 30th day of the bankruptcy case, the Debtors filed a motion seeking a further extension of time to file their Schedules of Assets and Liabilities and Statements of Financial Affairs. The Schedules and Statements had not yet been filed and that motion had not yet been heard by the July 15th hearing.
- Following the conversion of the case, Ubdaded and BSI made themselves unavailable to the Trustee. She then looked to Harrelson Tallahassee and TCW for cooperation and assistance. TCW, however, was engaged pursuant to an engagement letter and application that limited its role to that of "local counsel". Moreover, TCW's prepetition fees were not paid in full, the Carve-Out did not fully cover its pre-conversion fees and no money was being offered to TCW for the additional post-conversion work it was being asked to do.
- Despite the failure of the sale process, BBCS was still holding the $500,000 advance it received prior to the filing. Its retention application had not yet been heard by the Bankruptcy Court at the time of the conversion of the cases. BBCS would never have an opportunity to earn the success fee contemplated by its engagement letter.
- Romero remained hostile and uncooperative. CRO Alan had moved on to his next engagement (in Hong Kong), leaving him with very little availability for the Trustee.

- Soon after Alice Milla ws appointed as the Trustee, she received a call from former Development employee and Committee member, Peyton Wells. Wells, who lived in Badger City, the location of the R&D Facility, told the Trustee that the utility company had recently shut off electricity to the R&D Facility. The R&D Facility was running on generator and battery back-up power, which would last for only another 48 to 72 hours. Wells claimed that the potentially deadly variant of the Q-Virus (which was being used in testing to develop a more effective zombie repellant) was stored in the R&D Facility and could pose a danger to Badger City and surrounding areas if not kept in deep freeze. Milla had no technical background. The only cash to which she had access is the $50,000 set aside per the conversion order.

- New zombie pandemic narrowly averted, trustee Alice Milla set out to collect and monetize the estates' remaining assets. She was then approached by Romero and Umbrella Capital (buddies again) who offered her $2 million to buy the entire patent portfolio. All indications from her diligence to date were that the patents had limited value after the CDC had developed a vaccine and partially effective cure for zombification. The Trustee accepted the offer and the transaction was approved as a private sale by the Bankruptcy Court. A year later it closed, the Trustee learned from another former Development employee that Romero and a few others at ZAPS knew that the patented active ingredient in Zombie Off! was even more effective as a deer repellant. The commercial potential of that product was extraordinary (though dwarfed by the commercial potential of a zombie repellant when there was a zombie plague ongoing). By then, Umbrella Capital and Romero had already recouped their investment in "Z-Deer Be Gone!" many times over. Prior to the sale, Trustee Milla had examined Romero under oath at the 341(a) meeting. He hadn't mentioned the deer repellant application, but then again she hadn't then known to ask about it.

- In mid-August 2024, Trustee Milla received correspondence from the landlord for the Headquarters Lease asserting that the lease would expire September 30, 2024 (even if not deemed rejected earlier) and that the Debtors must then vacate. The Trustee was distressed by this development because the Debtors' servers with most of their customer and employee data were located at the Headquarters, together with most of the Debtors' other books and records. Moreover, the Trustee had recently received several expressions of interest from parties interested in taking an assignment of this highly desirable space. She reviewed the Headquarters Lease and realized that the Debtors had not exercised the option before the 90 day period. The last day to exercise the option passed during the interval after the cases were filed but before they were converted to chapter 7.

- One of the principles of BPOF dated Trustee Milla's roommate during law school and still blames her for breaking up the relationship. He, accordingly, attempted to rally creditor support to elect a different trustee. Both BPOF and Umbrella Capital attempted to submit ballots voting the deficiency portions of their respective claims. It was clear that they were both significantly undersecured, but by how much remained undetermined. Seven other creditors, each legitimately unsecured, voted in the trustee election: three voted to elect a new trustee; and the other four voted to stick with Milla.

Dramatis Personae

ABL Facility: The asset-based loan facility provided to ZAPS by CNB, as agent and the ABL Lenders.

ABL Lenders: The entities from time to time lenders under the ABL Facility.

Alan: Dennis Alan of Rainbow Spirit Turnaround Solutions, the crisis manager hired by the Debtors as CRO.

BBCS: Bare Bones Capital Services. The investment banker hired by the Debtors.

BPOF: Body Parts Opportunities Fund XIII, L.P., a value investor that acquired the Notes in late 2013 and early 2014.

Bridge Facility: $10 million short term loan provided by Umbrella Capital in May 2013 and secured by IP assets held by Development.

BSI: Blood, Sweat and Innards, PC. The law firm hired by the Debtors as general bankruptcy counsel.

CNB: Crypto National Bank, agent and lender under the ABL Facility.

Committee: The Official Committee of Unsecured Creditors appointed in the Debtors' chapter 11 cases.

CRO: Chief Restructuring Officer, Dennis Alan.

Debtors: Holdings, Operations, Fulfillment, and Development.

Development: ZAPS Development LLC, a Delaware LLC and a direct subsidiary of Holdings. ZAPS conducts its research and development functions through this entity. One of the Debtors.

Fulfillment: ZAPS Fulfillment LLC, a Delaware LLC and a direct subsidiary of Holdings. ZAPS conducts its order fulfillment operations through this entity. One of the Debtors.

Gray: Matheson Gray, named partner of Gray & Matters, LLP, Committee counsel.

Grimes: Dr. Richard Grimes, noted academic and ethno-biologist. Independent board member of Holdings.

Headquarters Lease: The lease for ZAPS' corporate headquarters located outside of Atlanta, Georgia.

Holdings: ZAPS Holdings, Inc., a Delaware corporation and the ultimate parent of the ZAPS family of companies. One of the Debtors.

NEPTOW: Not an Evil Plot to Take Over the World, LLC. Entity formed by BPOF and Umbrella Capital to acquire assets of ZAPS.

Notes: The high yield secured notes issued by Holdings and guaranteed by the other Debtors in June 2012.

Operating: ZAPS Operating LLC, a Delaware LLC and a direct subsidiary of Holdings. ZAPS conducts its retail operations through this entity. One of the Debtors.

R&D Facility: ZAPS' special purpose built research and development facility, which is owned and operated by Development and located in Badger City, Pennsylvania.

Romero: Mas A.B. Romero, the founder and CEO of ZAPS. Former founder of ZF Home.

Tallahassee: Harrison Tallahassee, partner at the TCW law firm.

TCW: The Delaware law firm hired as local bankruptcy counsel with BSI.

Trustee: Alice Milla, interim chapter 7 trustee for the Debtors' estates.

Ubdaded: Shaun Ubdaded, Dr. Grimes' brother in law and partner at BSI law firm.

Umbrella Capital: Umbrella Capital Partners, Inc., private equity fund that buys 40% stake in ZAPS. Co-invested with Romero in ZF Home and eventually purchased that business.

ZAPS Supercenter®: One of four regional retail outlets for ZAPS products. Twelve were originally planned.

ZF Home: Romero's prior successful start-up, which he sold to Umbrella Capital in early 2017.

AN INTRODUCTION TO SOME ISSUES IN CHAPTER 7 ASSET CASES CONVERTED FROM CHAPTER 11

By Gary F. Seitz

Chapter 7 Panel Bankruptcy Trustee (USBC ED PA)

Partner, Gellert Scali Busenkell & Brown, LLC

The panel before you today will address the key issues arising in the context of conversion: (1) Professional Retention, (2) Privileges, (3) Discovery and – all important - (4) Compensation. My goal is to provide a backdrop and introduction to their presentations.

Traditionally, Chapter 11 of the U.S. Bankruptcy Code was used to facilitate management's rehabilitation of a troubled company, while Chapter 7 offered a streamlined process for liquidating a business under the supervision of an appointed trustee. Today, debtors increasingly are filing for bankruptcy protection in Chapter 11 with no intention of reorganizing in the traditional sense. In other cases, the debtor is simply unable to confirm a plan. A failed Chapter 11 case is often converted to a Chapter 7 case or results in the appointment or election of a trustee who will take control of company assets and operations. Most Chapter 7 cases are non-operating liquidations conducted by an appointed or creditor-elected trustee with little knowledge of the operation of the business of the debtor.

A Chapter 7 bankruptcy typically ends a business's operations. The business may not operate in Chapter 7 without an order under Section 721 of the Bankruptcy Code. Although there are various obligations of the debtor triggered upon conversion, counsel for the debtor may not be paid. The conversion process involves notifying the United States Trustee of the business debtor's intent to convert the bankruptcy to Chapter 7 and asking for input toward a smooth transition.

How to get there: Conversion is not automatic.

Moving to convert to Chapter 7 bankruptcy should be supported with specific reasons. See 11 U.S.C. § 1112(a). Section 1112(b) of the Bankruptcy Code grants a bankruptcy court the authority to dismiss a chapter 11 case or convert it to one under chapter 7, "whichever is in the best interests of creditors and the estate, if the movant establishes cause . . . ." 11 U.S.C. § 1112(b). The term "cause" is not defined by the statute; the examples provided by subsection 1112(b)(4) are meant to be nonexclusive. See, e.g., In re Gilroy, 2008 WL 4531982, at *4 (B.A.P. 1st Cir. 2008) ("Section 1112(b)(4) provides a nonexclusive list of what constitutes cause."); In re Broad Creek Edgewater, LP, 371 B.R. 752, 759 n.8 (Bankr. D.S.C. 2007) ("Section 1112(b)(4) contains a nonexclusive list of sixteen scenarios which constitute cause."); see also In re Brown, 951 F.2d 564, 572 (3d Cir. 1991); Hall v. Vance, 887 F.2d 1041, 1044 (10th Cir. 1989), And therefore factors other than those expressly enumerated in the statute may be considered, and the bankruptcy court has the discretion to reach the appropriate result in a particular case. See, e.g., In re American Capital Equipment, LLC, 2008 WL 4597221, at *2 (3d Cir. 2008) (non-precedential); In re PPI Enterprises (U.S.), Inc., 324 F.3d 197, 211 (3d Cir. 2003). Generally, a court should consider the "totality of the circumstances" in considering relief under section 1112(b). See Perlin v. Hitachi Capital America Corp., 497 F.3d 364, 372 (3d Cir. 2007).

Cause exists to dismiss or convert a chapter 11 case when any of the enumerated provisions of section 1112(b)(4) are applicable. Among the examples of cause are: "material default by the debtor with respect to a confirmed plan." 11 U.S.C. § 1112(b)(4)(N). If cause for relief under section 1112(b) is

demonstrated, and if the provisions of section 1112(b)(2) are inapplicable, a court typically will determine whether dismissal or conversion is more appropriate. See, e.g., In re Superior Siding & Window, Inc., 14 F.3d 240, 242 (4th Cir. 1994) ("A motion filed under this section invokes a two-step analysis, first to determine whether 'cause' exists either to dismiss or to convert the Chapter 11 proceeding to a Chapter 7 proceeding, and second to determine which option is in 'the best interest of creditors and the estate.'"); In re Camden Ordnance Mfg. Co. of Arkansas, Inc., 245 B.R. 794, 798 (E.D. Pa. 2000); In re Mechanical Maintenance, Inc., 128 B.R. 382, 386 (E.D. Pa. 1991),

Determining Assets Subject To Administration: Property Of The Estate In Converted Cases

When a bankruptcy case converts from Chapter 11 to Chapter 7, the case sometimes has assets for a trustee to administer. This kind of case may have issues not found in an asset case initially commenced under Chapter 7. Section 704(1) of the Bankruptcy Code requires the trustee to collect and reduce to money property of the estate. In a converted case it is sometimes more complicated to determine exactly what that property is. While property of the estate is ordinarily fixed as of the date the case is filed, that general rule is more difficult to apply and is subject to exceptions in converted cases.

Section 541(a)(6) of the Bankruptcy Code renders "proceeds, product, offspring, rents, or profits of or from property of the estate, except such as are earnings from services performed by an individual debtor after the commencement of the case" property of the estate. The effect of this provision in Chapter 11 cases can be dramatic because debtors under that chapter typically operate a business and acquire and dispose of property. Thus, when a Chapter 11 case converts to Chapter 7 the debtor's schedules, which give a snapshot of its assets as of the date of filing, may not be that instructive regarding what the debtor's assets are as of the date of conversion.

Fed.R.Bank.P. 1019(5) does require the debtor to file a final report and account 30 days after conversion. Among the purposes of that report is to provide the trustee with a more accurate view of what there is to administer. Unfortunately, many debtors never file the report or do not do so timely or completely. Of course, even if the report is filed timely, the trustee in a converted case does not have the luxury of waiting 30 days to take control of the assets, but must do so quickly with the assistance of the debtor and whatever other parties are familiar with the debtor's assets. The importance of early response in determining those assets cannot be too strongly emphasized in converted Chapter 11 cases.

Occasionally Chapter 11 cases convert to Chapter 7 after having first confirmed a plan of reorganization. In addition to the difficulties mentioned above, the trustee in such a scenario must then determine what effect confirmation of the plan has upon assets to administer.

Pursuant to Section 1141(b) of the Bankruptcy Code "except as otherwise provided in the plan or the order confirming the plan, the confirmation of a plan vests all of the property of the estate in the debtor." Where neither the plan nor order confirming the plan carve out such exceptions, the estate dissolves upon confirmation. In re Harstad, 39 F.3d 898, 904 (8th Cir. 1994). In that event there is no property for the trustee to liquidate, all assets having vested in the debtor at confirmation. See In re T.S.P. Industries, Inc., 120 B.R. 107 (Bankr.N.D.Ill. 1990)(declining to convert case with confirmed plan for lack of estate to administer). But see Donaldson v. Bernstein, 104 F.3d 547, 554 (3d Cir. 1997) (affirming a decision by the bankruptcy court that allows the chapter 7 trustee to make distributions to creditors in the amounts promised by the confirmed chapter 11 plan); In re Consolidated Pioneer Mortg.

Entities, 264 F.3d 803, 807 n.5 (9th Cir. 2001) (and cases cited); In re Smith, 201 B.R. 267, 274 (D. Nev. 1996), aff'd, 141 F.3d 1179, 1998 WL 133445 (9th Cir. Mar. 20, 1998); In re Hughes, 279 B.R. 826, 829-31 (Bankr. S.D. Ill. 2002); 3 Collier on Bankruptcy, ¶ 348.02[1], at 348-8 (16th ed 2012) ("[C]ourts have not agreed with respect to what property is in the estate when a chapter 11 case is converted to chapter 7 after confirmation of a plan.").

Of course, it does not follow that in such cases the trustee has nothing whatever to administer. Pursuant to Section 541(a)(3) of the Code the trustee still may create a sizeable estate based on an assortment of causes of actions, including preferences and fraudulent conveyances, among others. Even with respect to such causes of action, however, the trustee in a converted Chapter 11 case with a confirmed plan must look closely to the plan and order confirming it for direction as to what, if any, rights the trustee has to prosecute those actions. See In re NTG Industries, Inc., 118 B.R. 606 (Bankr.N.D.Ill. 1990)(Debtor's right to pursue preferences under confirmed plan passed to Chapter 7 trustee upon conversion).

Determining The Universe Of Claims Entitled To A Distribution In Converted Cases

A second issue which is more complicated in a converted case is determining the universe of claims arguably entitled to distribution. During the Chapter 11 case the debtor may have accrued additional unpaid debt to that originally scheduled. While creditors of the debtor in possession (hereafter "DIP creditors") are entitled to share in the ultimate distribution, they cannot do so if they lack notice. Thus, Fed. R. Bank. P. 1019(5) requires the debtor to file a final report of post-petition debts. If the report is filed before the bar date notice is mailed to creditors, there generally is no problem. If, however, the report either is not filed or is filed after the bar date notice has been mailed to creditors, such DIP creditors may be divested of their right to a dividend, unless the trustee takes remedial action.

In the case of no debtor in possession report, the trustee may file a motion requesting the court to compel the filing of the report by the debtor. For non-individual debtors, the trustee may also consider requesting the court to designate an individual as the debtor pursuant to Fed. R. Bank. P. 9001(5) in order to aid compliance. If the debtor in possession report is filed after the bar date has been mailed to creditors, the trustee should request the court to set a bar date for DIP creditors. Remember, only after creditors have had their opportunity to file claims or requests for payment of administrative expenses and the trustee has reviewed and had objections to them determined by the court, is the case ripe for closing.

Determining The Proper Amount Of A Claim In Converted Cases

Another complication in a converted case is determining whether a claim is filed for the proper amount. This is especially nettlesome where a plan has been confirmed before conversion, (but there is an estate to administer because the plan or order confirming the plan did not vest all property in the debtor). In making the determination a preliminary and unresolved question is whether a claim should be allowed based on the amount due when the case was filed or whether the starting point is what the confirmed plan provided.

Suppose, for example, that a creditor had a $100 claim on the date the case was filed. The plan provided for a 10% payment or $10. Suppose, further that the creditor had in fact received $5 in plan payments before the case converted to Chapter 7. Under the first alternative the creditor has a claim for

$95 ($100 minus the $5 plan payment). Under the second alternative the creditor only has a claim for $5 ($10 due under the plan minus the $5 plan payment).

The first alternative appears to disregard the plan and Bankruptcy Code sections which provide that the plan binds creditors. See 11 U.S.C. §§ 1141(a), 1227(a) & 1327(a). Nevertheless, in the Chapter 13 context at least one court has held that the plan is no longer binding if the debtor fails to make plan payments and converts the case to Chapter 7. In re Pearson, 214 B. R. 156, 161 (Bankr. N.D. Ohio 1997).

The second alternative recognizes the binding effect of plans. So, for example, in a serial Chapter 11 case, In re Sportpages Corp., 101 B.R. 528 (N.D. Ill. 1989), the court limited a creditor's claim to the amount remaining to be paid under the debtor's first confirmed plan, although that plan had only been partially performed. The court did not allow the creditor's claim based on the amount due at the time the debtor's first case was filed.

Layer on top of that, Federal Rule of Bankruptcy Procedure 1019(3)—amended in 1987 to overrule the result in decisions such as In re Crouthamel Potato Chip Co., 786 F.2d 141 (3d Cir. 1986), see, e.g., Matter of Fesco Plastics Corp., Inc., 908 F.2d 240, 242-43 (7th Cir. 1990)—which provides that, upon conversion of the case from chapter 11 to chapter 7, only claims actually filed on the claims register will be deemed allowed. See, e.g., In re L. Meyer & Son Seafood Corp., 188 B.R. 315, 319 (Bankr. S.D. Fla. 1995).

Of course, before making a distribution the trustee will still have to determine how much was promised to be paid and how much in fact was paid under the plan. Determining how much was actually paid under a plan is more difficult than determining what was promised to be paid under the plan. In addition to consulting with the plan proponent and creditors, the trustee may review the final report and account of the debtor. Only by so doing will the trustee be in a position to make applicable credits and thereby determine the proper dividend to creditors.

Determining The Priority Of United States Trustee Quarterly Fees In Converted Cases

Another issue that arises only in cases converted from Chapter 11, is the status of unpaid United States Trustee quarterly fees. When a Chapter 11 case converts to Chapter 7 there are often unpaid fees owed to the United States Trustee pursuant to 28 U.S.C. §1930. These fees have the same priority as Chapter 7 costs of administration and Clerk's fees. Because the unpaid fees may be substantial, sometimes there is little or no other money available to pay other claims, even Chapter 11 administrative ones. This has resulted in challenges to the priority of these fees, notwithstanding the apparently clear language of Section 507(a)(1) of the Code.

Further, while the United States Trustee generally files a proof of claim or request for administrative expense for the unpaid fees, such filing is for informational purposes only and is no more required than for Clerk's fees. Therefore, trustees must check with the United States Trustee's Office prior to preparing a proposed distribution to determine whether there are any outstanding United States Trustee fees owed. Under Section 726(a)(1) of the Code this claim may be filed at any time prior to the trustee's distribution and still retain its priority status.

Determining Trustee Fees In Converted Cases

Another complicated wrinkle in a converted case is determining trustee and professional fees. Section 326 imposes a cap on trustee compensation. The formula has changed over the years. The applicable percentage fee cap is determined by the statutory language of Section 326 in effect on the date the case was filed, not the date the case was converted or any other date. Therefore, the case trustee must be cognizant of the applicable fee schedule for the case in question and not assume it is the one currently in effect.

Determining Professional Fees In Converted Cases

The final issue which is more complicated in a converted case is how to deal with fees of professionals from the debtor in possession period. In converted cases there are frequently professionals who have received retainers or interim compensation prior to conversion. In order to close a case all compensation issues must be finally determined. Thus, the trustee may have to request the court to compel professionals to file final fee applications or conduct a review of fees under Section 329 of the Code.

Furthermore, once all professional fees are allowed as final, there may be insufficient funds to pay them. If professionals have received interim allowances, the trustee should consider whether it is appropriate to request the court to order disgorgement so that all claims of the same priority receive the same percentage distribution. While trustees may be reluctant to do so, the integrity of the bankruptcy system requires trustees to consider this issue and reach a principled decision on how best to close a case with this problem.

Conclusion

As the panel will illustrate, there are a number of daunting issues in cases converted to Chapter 7. It is hoped that by providing a better understanding of those issues this panel will increase the likelihood that such cases will be successfully administered.

Outline for Delaware Bankruptcy Inn of Court April 8, 2014 Panel Presentation

RETENTION ISSUES APPLICABLE TO FORMER DEBTOR'S COUNSEL

Retention As Special Counsel

- The Concept of Special Counsel
  - Appointment of a Chapter 11 Trustee terminates the retention of debtor's counsel (along with all other professionals retained by the debtor). To the extent debtor's counsel seeks to continue to serve the Chapter 11 Trustee as special counsel, it must be explicitly retained for that purpose.
    - *Lamie v. U.S. Trustee*, 124 S. Ct. 1023, 1029 (2004) (noting termination of debtor as debtor in possession, terminate a professional's retention under 11 U.S.C. § 327 as a debtor in possession professional).
  - The retention of former debtor's counsel as special counsel by a trustee is explicitly authorized by the United States Supreme Court in *Lamie v. U.S. Trustee*, 124 S. Ct. 1023 (2004).
    - *See Lamie*, 124 S. Ct. at 1032 ("Sections 327 and 330, taken together, allow chapter 7 trustees to engage attorneys, including debtor's counsel, and allow courts to award them fees.").
- Absent Retention as Special Counsel, Former Debtor's Counsel May Not Receive Compensation For Otherwise Appropriate Services Rendered Following Appointment of a Trustee
  - While former debtor's counsel is required to cooperate with a trustee (*See discussion below)*, compensation is not guaranteed unless former debtor's counsel is explicitly retained by the trustee.
    - *In re Weinschneider*, 395 F.3d 401, 403-04 (7th Cir. 2005) (noting that unless counsel is retained under Section 327 of the Bankruptcy Code, counsel will not be compensated for efforts made on behalf of the debtor following appointment of a trustee);
    - *In re Starbak, Inc.*, 2010 WL 3927504, at *7 (Bankr. D. Mass. Sept. 29, 2010) (denying fee application of counsel retained by debtor following appointment of a trustee for purposes of facilitating debtor's cooperation with Chapter 11 Trustee where counsel was not retained by Chapter 11 Trustee under 11 U.S.C. § 327(e)).
- The Impact of Potential Conflicts of Interest on Retention As Special Counsel
  - To the extent former debtor's counsel has an attorney client relationship with both the corporate debtor and the individuals managing its affairs, such counsel may be conflicted from serving as special counsel to the trustee.
    - *In re DeVlieg, Inc.*, 174 B.R. 497 (N.D. Ill. 1994) (holding that under Section 327(e) of the Bankruptcy Code, the trustee can hire an attorney "that has represented the Debtor, for a 'specified special purpose', if the attorney does not represent or hold any interest adverse to the estate and the appointment is in the best interest of the estate.").

        - *In re United Utensils Corp.,* 141 B.R. 306, 309 (Bankr. W.D. Pa. 1992) ("An attorney who renders legal advice to an individual associated with the corporation upon matters personally concerning that individual may render himself in a conflict of interest position. Rendition of any such advice will violate the mandate of the Bankruptcy Code under § 327(a) that the debtor may employ attorneys, etc. 'that do not hold or represent an interest adverse to the estate.' Such activity would also violate the mandate under § 327(e) that a debtor's attorney may be employed by the special counsel for a special purpose 'if such attorney does not represent or hold any interest adverse to the debtor or to the estate with respect to the matter on which such attorney is to be employed.' ").

    - However, prudence may weigh against the disqualification of former debtor's counsel as special counsel to the trustee based on the former counsel's knowledge and familiarity with the bankruptcy and related litigation.
        - *See In re O.P.M. Leasing Services, Inc.*, 16 B.R. 932, 938 (Bankr. S.D.N.Y. 1982) ("The realities and practicalities of bankruptcy administration in large, complex cases, such as these, makes it 'doubtful' that a court will sever an established trusteeship over multiple related corporations in cases that are well professed unless there is a showing of actual, present conflict incapable of any other equitable resolution, particularly where, as here, full disclosure of the potential for conflict was made at the outset.");
        - *See id.* (denying a motion to disqualify counsel on the basis of an alleged conflict because disqualification would have created unreasonable delay and expense, particularly where conflict of interest was fully disclosed at the outset).

<u>Representation By Former Debtor's Counsel Of Parties Other Than The Trustee</u>

- Where former debtor's counsel seeks to represent parties other than the trustee, Professional Rules of Conduct may function to preclude such representation because of duties owed by counsel to their former client (the trustee now standing in the shoes of the debtor).
    - For example, Under Delaware Rule of Professional Conduct 1.9, attorneys owe a duty to their former client to:
        - Maintain confidentiality; and
        - Not represent any other party in a "substantially related matter" to the matter he represented his former client in.

    - *See also In re Irwin Jaeger*, 213 B.R. 578, 593-94 (Bankr. C.D. Cal. 1997) (stating that because the trustee succeeds to the confidentiality and loyalty duties former debtor's counsel would otherwise owe to the debtor, debtor's counsel may be precluded from representing other defendants in the bankruptcy case).

Existing Management Must Cooperate With The Trustee But Cannot Be Compelled to Render Services

- *See In re G&G Transport, Inc.*, 1998 WL 898835, at *5 (Bankr. E.D. Pa. Dec. 22, 1998) (existing management has an obligation to cooperate with a Chapter 11 Trustee but cannot be compelled to remain with the company and manage its operations).

Several Bankruptcy Code Sections May Require Former Debtor's Counsel To Cooperate With The Trustee (Regardless Of Whether They Are Compensated)

- 11 U.S.C. § 542(e)
    - Section 542(e) provides, "Subject to any applicable privilege, after notice and a hearing, the court may order an attorney, accountant or other person that holds recorded information, including books, documents, records, and papers, relating to the debtor's property or financial affairs, to turn over or disclose such recorded information to the trustee."

    - Compensation for services ordered under Section 542(e) of the Bankruptcy Code is not required because unlike the turnover provisions of Section 543 which specifically provide that a court shall compensate a custodian, as defined by Section 101(11), for its reasonable fees, expenses and costs in connection with a turnover of the debtor's property, Section 542(e) does not authorize the payment of any expenses which might be incurred in the turnover of the debtor's records.
        - *See In re Hyde*, 222 B.R. 214, 218-19 (Bankr. S.D.N.Y. 1998), *rev'd on other grounds*, 235 B.R. 539 (S.D.N.Y. 1999) (burden of turnover on accountant holding debtor's records not a valid objection to turnover of debtor's records under 11 U.S.C. § 542(e)).

    - For example, former debtor's counsel may be compelled to assemble and deliver the debtor's documents and other information to the trustee.
        - *In re Hechinger Investment Co. of Delaware*, 285 B.R. 601, 613 (D. Del. 2002) (holding that under Section 542(e) a debtor's records held by third parties are subject to turnover to the debtor).

    - In addition, unlike under state law, former debtor's counsel cannot withhold the debtor's documents until their fees are paid.
        - *In re Hechinger Investment Co. of Delaware*, 285 B.R. 601, 613-14 (D. Del. 2002) (noting the legislative history of Section 542(e) suggests that the provision was intended to deprive attorneys, accountants and other third parties holding a debtor's records of the leverage acquired under state laws to receive full payment of professional fees over the debtor's other creditors when the information withheld is necessary to administration of the estate) (citations omitted);
        - *In re American Metrocomm Corp.*, 274 B.R. 641, 652 (Bankr. D. Del. 2002) (same).
    - However, while compensation is not guaranteed, former debtor's counsel can still pursue a lien under applicable state law against the debtor for unpaid fees.

    - *See In re American Metrocomm Corp.*, 274 B.R. 641, 650 (Bankr. D. Del. 2002) (noting bankruptcy courts may recognize the existence of a valid lien held by former counsel under state law on the files turned over).

- 11 U.S.C. § 341
  - Section 341 of the Bankruptcy Code requires that where a Chapter 11 case is converted to a Chapter 7 case, a representative of the debtor's estate must appear at a meeting of creditors. If the debtor is not an individual, Delaware local rules require that the entity be represented by counsel.

- 11 U.S.C. § 521
  - The text of Section 521 explicitly requires the debtor and its agents, including its counsel, to cooperate with the trustee insofar as it provides that the debtor shall, "(1) file a list of creditors, and unless the court orders otherwise, a schedule of assets and liabilities, a schedule of current income and current expenditures, and a statement of the debtor's financial affairs; … (3) if a trustee is serving in the case, cooperate with the trustee as necessary to enable the trustee to perform the trustee's duties under this title; (4) if a trustee is serving in the case, surrender to the trustee all property of the estate and any recorded information, including books, documents, records and papers relating to property of the estate, whether or not immunity is granted under Section 344 of this title; and (5) appear at the hearing required under section 524(d) of this title."

- 11 U.S.C. § 330
  - Section 330 provides the court with authority to monitor and supervise court appointed counsel's fees and actions. *Matter of Grabill Corp.*, 983 F.2d 773, 776-77 (7th Cir. 1993)
    - *See, e.g., In re Crivello*, 134 F.3d 831, 835-36 (7th Cir. 1998) (noting former debtor's counsel's refusal to cooperate with a Chapter 7 or Chapter 11 Trustee could constitute a breach of the former counsel's duty to the debtor and thereby authorize the court to reduce the compensation to which the former counsel would otherwise be entitled);
    - *In re Downs*, 103 F.3d 471, 477 (6th Cir. 1996) (holding "the bankruptcy court is vested with the inherent power to sanction attorneys for breaches of fiduciary obligations").

- Bankruptcy Rule of Procedure 2004
  - Bankruptcy Rule 2004 states, "on motion of any party in interest, the court may order the examination of any entity." This rule gives the trustee significant powers to investigate a debtor's financial affairs and, if necessary, could be used against a reluctant former counsel.
    - *See, e..g, In re Fundamental Long Term Care*, 489 B.R. 451, 477(M.D. Fla. 2013) (granting Chapter 7 Trustee's motion under Rule 2004 for turnover of litigation files from debtor's former counsel so it could prepare defense and investigate potential claims).

COUNSEL'S DUTIES UPON APPOINTMENT OF A CHAPTER 11 TRUSTEE/CONVERSION TO CHAPTER 7: DOCUMENT PRODUCTION & DOCUMENT PRESERVATION

I. INTRODUCTION

The fiduciary duties of a DIP and DIP counsel are defined and described by the Bankruptcy Code and accompanying Rules, the Rules of Professional Conduct and applicable case law. It is well settled that DIP counsel owes significant fiduciary duties to its client. Additionally, as the law currently stands, upon the filing of a Chapter 11 petition, DIP counsel's fiduciary duties expand to parallel many of the fiduciary duties of the DIP itself.

How are DIP counsel's fiduciary duties affected upon conversion or appointment of a Chapter 11 trustee?

It should be noted that the scope of this inquiry is limited to the issues of document production and preservation.

II. COUNSEL'S DUTIES WITH RESPECT TO DOCUMENT PRODUCTION & PRESERVATION (including electronic information)

Counsel's duties with respect to document production and preservation can be found in the Rules of Professional Conduct and applicable case law. Rule 1.15 of the Delaware Rules of Professional Conduct imposes a duty on counsel to hold, safeguard and preserve for a period of 5 years, property belonging to a client or third party.

Additionally, case law indicates that bankruptcy counsel has a professional ethical obligation to assist a debtor in fulfilling its duties under the Bankruptcy laws.[1]

[1] *See e.g. In re Brierwood Manor, Inc.*, 239 B.R. 709, 716 (Bankr. D. N.J. 1999) (Holding that counsel for former DIP may not be compensated for services provided to the debtor post conversion, unless such services assisted the debtor in fulfilling its duties under § 521); *In re Morey*, 416 B.R. 364, 365 (Bankr. D. Mass. 2009) (Holding that counsel for a Chapter 7 debtor is under a professional ethical duty to assist the debtor with her duty of cooperation with the Trustee); *Robb v. Sowers (In re Sowers)*, 97 B.R. 480, 487, 488 (Bankr. N.D. Ind. 1989) ("Among the obligations counsel assumes by representing a bankruptcy debtor is that of assisting the client to fulfill the duties imposed upon it by the Bankruptcy Code."); *Houghton v. Morey (In re Morey)*, 416 B.R. 364 (Bankr. D. Mass. 2009) (The Court disqualified debtor's counsel from representing non-debtor defendant in a fraudulent transfer adversary proceeding brought by the debtor's trustee in bankruptcy "[b]ecause [debtor's counsel] cannot fully and adequately assist the Debtor with her duty of cooperation to the Trustee and the bankruptcy estate while simultaneously representing [an entity whose interests potentially conflict with the Trustee]…");

If counsel fails to fulfill those duties, they may be subject to sanctions by the Bankruptcy Court. [2]

<u>*What are a debtor's duties with respect to document production?*</u>

In general, debtors are obligated to produce documents in the context of an adversary case or 2004 examination. Rules 7026 and 7034 of the Federal Rules of Bankruptcy Procedure set forth the document production rules in the context of an adversary case. Rule 7026 requires litigants in an adversary case to comply with the initial disclosure requirements set forth in Federal Rule of Civil Procedure 26. Specifically, Federal Rule of Civil Procedure 26 requires litigants to provide one another with "a copy-or a description by category and location- of all documents, electronically stored information, and tangible things that the disclosing party has in its possession, custody, or control and may use to support its claims or defenses…" Further, Rule 7034 provides that Federal Rule of Civil Procedure 34 applies in adversary actions. Specifically, Federal Rule of Civil Procedure 34 provides that litigants may request from one another the production of "documents or electronically stored information-including writing, drawing, graphs, charts, photographs, sound recordings, images, and other data or data compilations-stored in any medium from which information can be obtained…"

Section 521 of the Bankruptcy Code, Federal Rule of Bankruptcy Procedure 4002, and Local Rule 4002-1, all impose additional duties upon a debtor where a trustee has been appointed to serve in the case. Specifically, debtors are obligated to cooperate with the trustee and provide certain documentation to the trustee. Some Courts have gone so far as to say that a debtor's duty to cooperate with the trustee is actually shared by counsel.[3] Those courts reason that debtor's counsel has a fiduciary duty to the bankruptcy estate, even upon appointment of a trustee. The majority view, however, is that, upon appointment of a Chapter 11 trustee/conversion to Chapter 7, counsel for the debtor is relieved of any obligations it may have had to the bankruptcy estate while acting as DIP counsel.[4]

See also In re Cochener, 360 B.R. 542 (Bankr. S.D. Tex. 2007) (debtor's counsel, as an agent of the debtor, is not only obligated to assist their client in fulfilling their duties under the bankruptcy laws, but that debtor's counsel actually shares those same duties).

[2] *In re Cochener*, 360 B.R. 542 (Bankr. S.D. Tex. 2007).

[3] *See Agresti v. Rosenkranz (In re United Utensils Corp.)*, 141 B.R. 306, 309 (Bankr. W.D. Pa. 1992) ("An attorney for the [chapter 7] debtor has a fiduciary duty not only to the debtor, but has a fiduciary obligation to act in the best interest of the entire estate, including creditors."); *See also In re Cochener*, 360 B.R. 542 (Bankr. S.D. Tex. 2007).

[4] *See In re Brier Wood Manor, Inc.*, 239 B.R. 709, 716 (Bankr. D.N.J. 1999) ("In a chapter 11 reorganization, the debtor in possession has a fiduciary duty to act in the best interest of the estate and creditors… Upon conversion of the chapter 11 case to liquidation under chapter 7…the interests of the estate become the responsibility of the chapter 7 trustee."); *In re Nidiver*, 217 B.R.

What are a debtor's duties with respect to document preservation?

In addition to the implicit obligations of debtors to preserve certain documentation in connection with their document production duties discussed above, Federal common law imposes an express duty to preserve relevant documents when litigation becomes reasonably anticipated.[5] As for counsel, they "must oversee compliance . . . monitoring the party's efforts to retain and produce the relevant documents."[6] Specifically, attorneys are obligated to ensure all relevant documents are discovered, retained, and produced.[7]

The term often used to describe a litigant's failure to properly preserve evidence is called "spoliation." A finding of spoliation can result in an adverse inference against the spoliator, sanctions, or even denial of discharge (in the context of a chapter 7 case).[8]

Upon appointment of a Chapter 11 trustee, there is often an increased likelihood of litigation, and as such, a possible increased need for document preservation. Counsel

581, 583 (Bankr. D. Neb. 1998) (Finding that in a Chapter 7 case, the bankruptcy estate is administered by a trustee, and that "[d]ebtors counsel will not represent the bankruptcy estate, will not have a fiduciary duty to creditors, and will not be employed as a professional person to render services to be compensated from the bankruptcy estate."); *In re Doors & More, Inc.*, 126 B.R. 43, 45 (Bankr. E.D. Mich. 1991) ("[I]n Chapter 7, court approval of the debtor's attorney is not required because neither the debtor nor the debtor's attorney have any fiduciary obligation to the bankruptcy estate."); *Burtch v. Ganz (In re Mushroom Transp. Co.)*, 366 B.R. 414, 451 (Bankr. E.D. Pa. 2007) ("[O]nce a chapter 7 trustee is appointed there is no longer a debtor in possession; the chapter 7 debtor is not a fiduciary; and counsel for the chapter 7 debtor does not represent the trustee… Thus, debtor's counsel is not in a fiduciary relationship to the chapter 7 trustee upon conversion of the case."); *Houghton v. Morey (In re Morey)*, 416 B.R. 364, 367 (Bankr. D. Mass. 2009) ("Some courts have held that… an attorney for the debtor [in the context of a Chapter 7 case] has a fiduciary duty not only to the debtor, but has a fiduciary obligation to act in the best interest of the entire estate, including creditors. This Court respectfully disagrees and believes that the only duty which counsel for the debtor assumes is to his or her client.") (*internal quotations and citations omitted*).

[5] *See e.g. Quintus Corp. v. Avaya, Inc. (In re Quintus Corp.)*, 353 B.R. 77 (Bankr. D. Del. 2006) *Citing Howell v. Maytag*, 168 F.R.D. 502, 505 (M.D. Pa. 1996) (holding that a party who has reason to anticipate litigation has an affirmative duty to preserve evidence which might be relevant to the issues in the lawsuit); *Zubulake v. UBS Warburg LLC*, 220 F.R.D. 212, 2018 (S.D.N.Y. 2003) (Holding once a party reasonably anticipates litigation, it has a duty to suspend routine document destruction and establish a "litigation hold" to ensure the preservation of relevant documents.)

[6] *Zubulake v. UBS Warburg LLC,* 229 F.R.D. 422, 432 (S.D.N.Y. 2004).

[7] *Zubulake v. UBS Warburg LLC,* 229 F.R.D. 422 (S.D.N.Y. 2004).

[8] *See e.g. Hechinger Inv. Co. of Del., Inc. v. Universal Forest Prods. (In re Hechinger Inv. Co. of Del., Inc.)*, 489 F.3d 568 (3rd Cir. 2007); *Schmid v. Milwaukee Elec. Tool Corp*., 13 F.3d 76, 79 (3d Cir. 1994); *In re Siegmund Strauss, Inc.*, Case No. 13-10887 (MG), 2013 Bankr. LEXIS 2880 (Bankr. S.D. N.Y. July 17, 2013); *Anderson v. Wiess (In re Wiess)*, 132 B.R. 588 (Bankr. E.D. Ark. 1991).

must be wary of this fact, and act accordingly.

III. CONCLUSION

Bankruptcy counsel has a host of substantive legal pitfalls that must be avoided. As such, it is important for counsel to be cognizant of the breadth of their fiduciary duties while in Bankruptcy, and additionally, how those duties may change upon appointment of a Chapter 11 trustee/conversion to Chapter 7.

COMPENSATION FOR DEBTOR'S COUNSEL FOR WORK AFTER CONVERSION OR APPOINTMENT OF A CHAPTER 11 TRUSTEE

I. *Lamie* Held that Appointment of a Chapter 7 Trustee Terminates: (i) Debtor's Debtor-in-Possession Status, and (ii) Debtor Attorney's Retention Under Section 327 of the Bankruptcy Code

In *Lamie v. U.S. Trustee*, 540 U.S. 526 (2004), the Supreme Court resolved a Circuit split over the interpretation of the 1994 amendments to section 330(a) of 11 U.S.C. §§ 101, *et seq.* (the "Bankruptcy Code"). The prior version of section 330(a), permitted reasonable compensation and expense reimbursement to various parties, including "the debtor's attorney" or a "professional person employed under section 327 or 1103" of the Bankruptcy Code. The 1994 amendments removed the reference to "the debtor's attorney," and gave rise to a Circuit split regarding whether a debtor's attorney could be compensated unless such attorney was employed under section 327.

The Supreme Court in *Lamie* concluded that employment under section 327 of the Bankruptcy Code was required for a debtor's attorney to be compensated by the Bankruptcy estate. Because appointment of a Chapter 7 trustee "terminated [the debtor's] status as debtor-in-possession and so terminated [the attorney's] service under § 327 as an attorney for the debtor-in-possession," the attorney could not be compensated from estate funds in the absence of employment by the trustee and approval by the court pursuant to section 327. 540 U.S. at 532.[1]

[1] Courts have held that *Lamie* also applies upon appointment of a Chapter 11 trustee. *See In re Int'l Gospel Party Boosting Jesus Groups, Inc*., 487 B.R. 12, 15 (D. Mass. 2013) (citing cases).

These materials provide an outline of strategies debtor's counsel may employ to get paid for work post-conversion or appointment after *Lamie*.[2]

II. Getting Paid After *Lamie*

- Payment from Retainer
    - *In re Channel Master Holdings, Inc.*, 309 BR 855, 859 n.3 (Bankr. D. Del. 2004) ("Although the Supreme Court has held that, after conversion to chapter 7, debtor's counsel fees may not be paid by the estate, it did acknowledge that those fees may be paid from a retainer received prior to conversion. Since the post-conversion fees and expenses sought by counsel for the Debtors are less than the remaining retainer, they may be paid from it.") (internal citation omitted). Certain courts in other jurisdictions courts have limited the so-called "retainer exception" to a flat fee retainer. *See In re CK Liquidation Corp.*, 343 B.R. 376, 383 (D. Mass. 2006) (holding that debtor's attorney could not be paid from security retainer for post-conversion work).
    - Query whether debtor's counsel can ask for a post-petition pre-conversion retainer to cover these fees.
- Employment Under Section 327(e) as Special Counsel to the Trustee[3]
    - In *Lamie*, the Supreme Court noted that sections 327 and 330 allow Chapter 7 trustees to "engage attorneys, including debtors' counsel, and allow courts to award them fees." 540 U.S. at 537 (citing sections 327(a) and (e)).

[2] This outline is designed to provide a survey of recent case law and suggested strategies for practitioners. It is not intended to, and does not, express the view of the authors or their firms as to whether or to what extent such payment should be allowed.

[3] Ethical and practical issues regarding retention are discussed more fully in the accompanying "Retention Issues Applicable to Former Debtor's Counsel" materials prepared by Samuel L. Closic and R. Stephen McNeill.

- Under section 327(e), the trustee may employ the debtor's attorney "for a specified special purpose . . . if in the best interest of the estate, and if such attorney does not represent or hold any interest adverse to the debtor or to the estate with respect to the matter on which such attorney is to be employed." 11 U.S.C. § 327(e).

- Ethical and practical concerns:

  - Employment by the trustee may not make sense if the attorney is really representing the debtor.

  - Conflicts of interest

    - *See In re Hart Oil & Gas, Inc.*, No. 12-13558, 2013 WL 3992252, at *4 (Bankr. D. N.M. Aug. 2, 2013) (reasoning that "[b]ecause of potential solvency, the Debtor has standing in the case, is an interested party, and like secured and unsecured creditors, constitutes an 'interest adverse' to the estate" and concluding that the debtor's counsel could not represent the Chapter 11 trustee).

    - Other potential conflicts/concerns.

- Approval of Payment by Chapter 7 or Chapter 11 Trustee?

  - *See Lamie*, 540 U.S. at 537 ("Section 327's limitation on debtors' incurring debts for professional services without the Chapter 7 trustee's approval is not absurd."); *In re Schiff*, No. 04–14811, 2010 WL 3219535 (Bankr. S.D.N.Y. Aug. 10, 2010) (ordering payment of fees incurred by debtor's counsel following appointment of chapter 11 trustee where, *inter alia*, trustee had agreed that debtor's counsel should be paid from surplus funds, and retention of counsel by debtor had also been approved by the court after appointment of chapter 11 trustee, but ultimately not reaching the *Lamie* issue).

  - Consider whether, as a practical matter, pre-approval is possible. If fee application is not objected to, do courts interpret this as implicit consent, since some courts have been allowing these fees based on no objection?

- <u>Substantial Contribution</u>
  - *In re The Village at Penn State Retirement Community*, Case No. 11-08005 (Bankr. M.D. Pa. Sept. 12, 2013).
  - However, the language of section 503(b)(3)(D) only references chapter 9 and 11 cases, not cases converted to chapter 7. In addition, it applies to "a creditor, an indenture trustee, an equity security holder, or a committee . . . ."
- <u>Other</u>
  - Attorneys' liens. *But see*, *e.g.*, *In re CK Liquidation Corp.*, 343 B.R. at 383 (rejecting debtor attorney's argument that retainer was encumbered by state law property lien, and unaffected by the debtor's conversion to chapter 7).
  - Reaffirmation for the debt of attorneys' fees.
- <u>Seeking Payment From the Debtor</u>
  - *In re Schiff*, 2010 WL 3219535, at *6 (stating that "this Court need not reach the legal issue raised by *Lamie* because there appears no dispute that a debtor's counsel is not precluded from seeking payment from the debtor personally after dismissal of a case," and holding that reasonable post-conversion fees should be payable upon dismissal from surplus to be distributed to debtor).
  - *But see In re Int'l Gospel Party Boosting Jesus Groups, Inc.*, 487 B.R. 12, 15 (D. Mass. 2013) (holding that debtor's counsel could not be compensated from estate, including from surplus funds, for services incurred after appointment of chapter 11 trustee).[4]

[4] The court also distinguished *In re Lewis,* 346 B.R. 89, 102 (Bankr. E.D.Pa. 2006), which had awarded fees to debtor's counsel following dismissal of an individual Chapter 13 proceeding pursuant to section 349(b), noting that "11 U.S.C. § 330(a)(4)(B) makes compensation available to Debtor's counsel in individual Chapter 13 proceedings 'based on a consideration of the benefit and necessity of such services.'" 487 B.R. at 17.

Bankruptcy Workshop
ABI – Mid Atlantic

Commercial: Going Gently into that Good Night: The Process of Converting Cases to Chapter 7

Subject: Recommended "Documents/Disclosures to facilitate administration for Trustees in converted cases"

The following is a list of documents/information that the Delaware Panel of Trustees has assembled that would be most helpful in order to facilitate the successful transition of case administration to a Chapter 7 Trustee. This list is not intended to be all inclusive but would be most beneficial to the trustees upon conversion.

- Identify critical issues that require immediate attention (e.g. – the running of the statute of limitations);
- Current contact information – names, addresses, telephone numbers and email addresses – for all officers, as well as for debtors' management team members responsible for accounting, technology, IP, regulatory and HR functions;
- Identification of any 401(k) plans and the termination status. Also, the contact information for the plan administrator, auditor and investment firm;
- Copies of WARN Act preparation activities, notices and legal opinions, if any;
- Description of any need for security precautions and steps taken regarding same;
- Preservation status of servers, hard drives, backup tapes and list of assigned user IDs and passwords; or if the assets were sold, the agreement memorializing the document and data information sharing arrangement;
- List of all bank accounts, including bank contact information;
- Schedule of all licenses and/or contracts assumed and assigned or otherwise disposed of during Chapter 11 case, together with any cure amounts paid;
- Inventory of all environmental or hazardous material licenses. Also, any pending administrative or criminal actions pending;
- Schedule listing critical vendors paid and any stipulations with said vendors settling claim balances and potential preferences, and

Other Additional Helpful Documentation to assist in the Transition of Converted Cases

- Copies of all recent insurance policies/binders;
- Status of W-2 preparation for former employees, including contact information (with account numbers) for debtor's payroll service;
- Copy of the last two federal income tax returns;
- Identification and contact information for debtor's ordinary course professionals, as well as for debtor's pre-petition accountants, auditors, IP counsel, and/or regulatory counsel;
- Steps taken to secure personnel records and other personally identifiable employee or customer information;
- Most recent inventory (electronic format preferred);
- Copies of all loan documents under which debtor is a lender or borrower;
- Copies of all Chapter 11 sale documents, including purchase agreements with exhibits and schedules, as well as all closing binder documents;
- Inventory of complete IP portfolio, including identification of all patents, trademarks and copyrighted materials held, and any such applications pending;
- Copies of any special industry regulations applicable to asset disposition, along with current contact information for former employees who could serve as an estate consultant, if required, due to specialized or regulated industry;
- Any other information that Chapter 11 counsel would consider helpful to the Chapter 7 trustee upon conversion.