

# Daily Journal

## Understanding Process Is Key to Defending Adversary Proceeding

By Howard Madris

**B**ankruptcy Court can be a strange foray for a litigator accustomed to practicing in state courts or federal district courts, particularly when the bankruptcy trustee or debtor-in-possession sues the litigator's client in an adversary proceeding for money damages.

While sound litigation skills and a knowledge of the Bankruptcy Code are of course necessary, it is also important for the practitioner to have a working knowledge of the bankruptcy process. In particular, the litigator should understand how the dynamics of the underlying bankruptcy case and the other adversary proceedings may affect the litigation or settlement of the client's case.

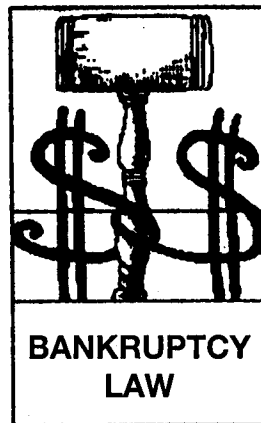
Knowing what assets the bankruptcy estate has to fund the adversary litigation can be a valuable tool. Such information is readily ascertainable from documents on file with the Bankruptcy Court, including the debtor's Summary of Schedules and Statement of Financial Affairs, which all debtors must file.

In addition, it is good practice to speak with counsel for the trustee or debtor-in-possession and to discuss matters such as what assets are in the estate (including cash), what other litigation and bankruptcy proceedings are pending or contemplated and what funds the debtor-in-possession or trustee anticipates generating for the estate from such other matters.

Furthermore, the practitioner should review the terms under which counsel has been employed to represent the estate in the adversary proceeding. The trustee or debtor-in-possession must file the application employing counsel or special liti-

gation counsel with the Bankruptcy Court.

Typically, in litigating an adversary proceeding, the counsel for the trustee or debtor-in-possession would be paid its hourly rate, which would accrue as a Chapter 7 or 11



administrative claim until the court allows the attorney's claim and authorizes payment from estate funds.

In formulating settlement strategy, it is important to understand the motivations of the estate's representative. For example, while a bankruptcy trustee has a fiduciary duty to act to maximize the distribution to the holders of allowed claims against the estate, no trustee wants to have an "administratively insolvent" case, where the estate lacks sufficient funds to fully satisfy allowed administrative claims, such as those of the estate's accountants, attorneys and other professionals.

For the defendant in an adversary proceeding, the above information can be greatly beneficial in formulating a settlement. For instance, consider the following hypothetical: The Chapter 7 trustee

recently served the defendant with a complaint for the avoidance and return of an alleged \$750,000 preferential transfer under 11 U.S.C. Section 547 (which allows the trustee to sue to recover property that the debtor transferred during a specific period of time before petitioning for bankruptcy). The defenses to the complaint are of uncertain merit. This claim is the estate's only asset. Unsecured claims against the estate total \$500,000, and there are no priority or secured claims. Administrative claims already total \$75,000.

In this scenario, it might make sense for the defendant to propose a settlement for perhaps \$125,000, even if the case is objectively "worth" more. The trustee might accept the settlement because it would result in full payment of all administrative claims (including the trustee's counsel's claim) and in a pro rata distribution to the holders of allowed unsecured claims.

In contrast, consider the same hypothetical, except that the estate has \$200,000 in cash rather than zero. Here, the trustee might be less risk-averse and disinclined to settle for \$125,000. The cash would serve as a "buffer" such that, even if the trustee were to lose the preference litigation, the estate would be able to pay all allowed administrative claims and make a distribution to general unsecured creditors. It might behoove the defendant to make a higher offer in this context.

In formulating settlement strategy, it is also worth considering whether the debtor-in-possession or trustee has commenced other, similar adversary proceedings. For example, if the trustee commenced 30

preference actions in the same case and settled some of those proceedings for 20 cents on the dollar, perhaps this indicates that the trustee might consider a similar settlement.

In addition, the defendant should consider whether the legal issues addressed in the complaint are the same issues that have been or are being litigated in other adversary proceedings arising from the same main bankruptcy case. For example, one defense to a claim for the avoidance of a preferential transfer is set forth in 11 U.S.C. Section 547(c)(2)(A), which provides that a transfer is not avoidable as a preference if it was made "in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee." If the trustee or debtor-in-possession has litigated 50 other adversary proceedings arising out of the main bankruptcy case, all for the avoidance of preferences, it is possible that, in one of those proceedings, the court might have determined what the "ordinary course of business" is in the debtor's industry. Armed with such information, the defendant can engage in more economical and effective litigation, whether it be by piggybacking on

other defendants' arguments or by essentially knowing in advance how the court may rule, based on the rulings in the other proceedings.

Finally, it is worth considering whether, because of other events in the main bankruptcy case, the trustee or debtor-in-possession has an incentive to settle the proceeding quickly, for less money. When funds are available, a trustee typically will try to make distributions to creditors and close the case as quickly as possible. Therefore, a trustee might have an incentive to settle for a lower amount if, for example, the proceeding is the only such proceeding remaining and is thus the only impediment to the trustee filing a final report and closing the main bankruptcy case.

Similarly, in a Chapter 11 case, the defendant's counsel should read the Chapter 11 plan of reorganization (if there is one) and ascertain how the plan treats the litigation. Although the terms of Chapter 11 plans can vary quite widely, a hypothetical plan might provide for all pending adversary litigation to be assigned from the debtor-in-possession to a "creditors' trust," for the benefit of creditors, on the plan's effective date. Before the effective date, the debtor-

in-possession would retain any proceeds arising from the settlement of adversary proceedings. In this context, the debtor-in-possession might settle for less money than it otherwise might be inclined to accept, provided that the settlement would be approved by the court before the plan's effective date, so the debtor-in-possession, rather than the creditors' trust, would receive the proceeds.

In summary, there is more to defending a bankruptcy adversary proceeding than merely having good general litigation skills and a working knowledge of the Bankruptcy Code. By understanding the big-picture dynamics of the main bankruptcy case and the other adversary proceedings, a litigator can obtain the best result for the client.