 

WorthReading

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Comfort Orders:
Protect Yourself from Unnecessary and Costly Litigation

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Most businesses will experience a bankruptcy by a customer or otherwise affecting the business' secured collateral. What do you do if your collateral is listed in a bankruptcy matter or you have repossessed the collateral and are later notified of a bankruptcy filing affecting the collateral? If your customer has filed for bankruptcy protection, the matter is usually straightforward. An automatic stay immediately applies to all actions (judicial, self-help, or otherwise) against your client, property owned by your client or property in your client's possession. You should immediately seek an Order for Relief from the Automatic Stay. Commencing or continuing any actions against your client or client's property is a clear violation of the automatic stay.

Debtors don't always make it so simple. Sometimes debtors list collateral from multiple companies. Debtors also sometimes list equipment the debtor's owners/executives finance or lease individually. The property may be listed in the bankruptcy by the customer or an insider to stall any action against such collateral if the other companies or the insider are in default. Listing the collateral in a single bankruptcy saves the insider or other company from having to also file.

Example: Creditor leases various pieces of equipment.

Equipment #1 (EQ1) is leased to debtor company #1 (DC1).
The owner of the debtor company also owns company #2.
Equipment #2 (EQ2) is leased to company #2 (C2).
Equipment #3 (EQ3) is leased to the owner of DC1 individually.
Equipment #4 (EQ4) is leased to DC2. EQ4 is not listed in the petition.

All the accounts are over ninety days past due. DC1 files for a Chapter 11 bankruptcy and lists EQ1, EQ2, and EQ3 in the bankruptcy petition. Can you repossess any of the items?

What happens when a non-party to a bankruptcy (e.g.: owner, relative, related company) files for bankruptcy and lists your equipment as property of the estate to prevent a repossession? Does the automatic stay apply?

Answer: Maybe. The answer may not be certain under the facts. The penalties for guessing wrong and violating the automatic stay may be substantial.

Solution: Obtain a Comfort Order!

Upon the filing of a bankruptcy case by a debtor, the law provides an automatic stay of claims against any interest of the bankruptcy estate. Under the threat of significant potential sanctions, the automatic stay prevents any action against property of the estate. The automatic stay mandates that activities such as court actions, self-help repossessions, offsets, etc., must be stopped immediately. As a general rule the bankruptcy estate is comprised of all the property of the debtor at the time of the filing of the bankruptcy case. Possession can be actual or constructive. Established case law identifies what should and should not be considered part of the bankruptcy estate. Acts against property that are not part of the bankruptcy estate should not be a violation of the stay. Determining whether property is a part of the estate is heavily litigated. Every year parties litigate the scope of the bankruptcy stay and the authority of the Bankruptcy Judge to manage a bankruptcy case. The litigation is often very costly to the creditor in both fees and time. Winning is rarely a comfort. Creditors in Bankruptcy Court seldom recover their fees. Keeping your expenses and time expended to a minimum is essential. The simple and economical solution is to obtain a "Comfort Order."

In our example, the debtor has listed four pieces of equipment as property of the estate, and you are aware of at least one other unlisted piece of equipment that may be used indirectly by the debtor (EQ4). At first, as a non-attorney, it may seem obvious to you that certain pieces of equipment are not part of the bankruptcy estate as the second company and the individual owners are not related to the bankruptcy filing.

Notwithstanding your non-legal opinion, do not attempt to repossess these pieces of equipment by self-help or through state court action, until you consult with a knowledgeable bankruptcy attorney and obtain a Comfort Order or an Order Granting Relief from the Automatic Stay, as applicable.[1] Provide your attorney all the factual information affecting any property you

[1]This article does not address which example requires a Comfort Order and which example requires an Order for Relief of the Automatic Stay. At least one of the examples of property in this article is certainly part of the bankruptcy estate. An argument can be made that all of the property is covered under the automatic stay. The examples were selected to show how difficult it may be to determine what property is part of the estate.

are looking to recover. Deciding on a course of action is heavily fact intensive. Local case law or local Judges may permit a different solution. Providing your attorney information up front may help reduce costs in the end.

You should provide your attorney:

1) The lease agreements and title showing proof of ownership and lien if applicable. A current lien/UCC search should be ordered to confirm your perfected lien has not been stripped/removed, if applicable.

2) If it is a recourse lease, proof of re-assignment of the lease. The assignment is often written as a complete assignment, despite the fact that the intent was to only assign the stream of payments. If you do not have an immediate right to possession your application for relief from the automatic stay against the collateral may be rejected, but you will have needlessly spent time and money.

3) The source of payments on the leases. If DC2 was making the payments on equipment for DC1, under some circumstances, the two companies may be deemed one and the same. The property may be considered de facto property of either company and potentially part of the bankruptcy estate.

4) All statutory notices and correspondence between the parties, including emails. Failure to provide the entire story may cause your counsel to select the wrong course of action or cause the creditor to incur unnecessary attorneys' fees and expenses.

The Judge, Debtor, and/or Trustee may disagree about which property is part of the bankruptcy estate. Of course, the debtor has listed the items in bankruptcy to protect them from repossession. If you attempt to repossess the equipment, you could be walking into a trap.

How could a judge say EQ2, EQ3, or EQ4 are considered property of the bankruptcy estate? Although you might assume they have no relationship to the debtor (DC1), this assumption may be incorrect. The debtor may have changed the nature of the business. Even though your contract does not permit assignment or sale of the property without your consent, rights to the property may have been assigned to DC1. The debtor could allege that the equipment is necessary for the reorganization. This allegation could be absurd. Nonetheless, a judge could say that an issue of fact exists. The judge may order a hearing or a trial to determine ownership of the property or whether you violated the automatic stay. (More attorney fees and more time wasted.) Time is money, and your collateral is depreciating.

If you begin or continue any action against the property, the judge, debtor, or trustee could accuse you of violating the bankruptcy stay. Their interpretation could be mistaken, but the resulting litigation is almost guaranteed to be more expensive than obtaining a Comfort Order or

Order for Relief from the Automatic Stay. If you regained possession through self-help, you could be accused of wrongful repossession in addition to the violation of the bankruptcy stay. Depending on the extent of the alleged violation, the judge, debtor or trustee could make a motion for sanctions, as well as a claim for lost profits and other damages.

The consequences can vary. You may be required to return the property to the debtor or non-party. The court can award non-monetary sanctions (e.g.: forfeit your ownership rights and be deemed an unsecured creditor) or order you to pay the debtor's or non-party's damages and/or the trustee's attorneys' fees. You will also have to pay your attorney's fees which could easily range from $5,000 - $10,000 to defend the matter. Defending a matter is almost always more expensive than obtaining a Comfort Order.

Why does it make sense?

1) If the debtor improperly listed the equipment, expect them to allege improper acts (eg: wrongful repossession) if you act outside the bankruptcy.

2) When appearing before the court, you do not want to be known as the bad actor! Bankruptcy judges have equitable powers and take notice of bad actors (e.g.: parties ignoring the automatic stay, other bankruptcy rules or the judge's authority). Instead, you want the one who tried to improperly hide the other party's collateral in the bankruptcy estate to be considered the bad actor for abusing the bankruptcy process.

3) Good Faith carries substantial weight in the eyes of a bankruptcy judge.

A "Comfort Order" is obtained through filing a motion with the bankruptcy court. The amount of attorney's fees should cost between $750 and $2,000. The fees will be affected by (1) the type of case (Chapter 7, 11 or 13); (2) whether a court appearance is required; (3) the hourly fee or flat fee arrangement made with your counsel; (4); whether the debtor or trustee objects, and the length of their opposition briefs; and (5) other factors. An objection may be filed by the debtor to obtain leverage for the debtor or trustee to delay the sale of the collateral, to permit the trustee or debtor to sell the collateral themselves or obtain other concessions from the creditor.

For example our office recently recommended to a client to obtain a Comfort Order. The client agreed. The debtor's counsel filed a weak objection. At the hearing to obtain the Comfort Order the Judge indicated the propriety of seeking a Comfort Order which resolved several factual issues. The owner of the debtor company had been hiding the collateral at the debtor's property. The collateral was recovered shortly thereafter.

Practice Tip #1: If you need to seek a Comfort Order, request that the Court order additional relief directing the debtor to disclose the location of the collateral and immediately surrender the collateral to the creditor if within the debtor's possession or control. (The Court may refuse to

provide the relief because the Comfort Order is a determination that the collateral is not part of the debtor's bankruptcy estate.) If the Court does grant such an order, and the debtor willfully fails to comply with the order, then the debtor may be found in contempt of Court. You will be better protected.

Practice Tip #2: Check to see if the debtor has the required insurance policies in place as required under the lease agreement or other agreements. Judges recognize the importance of having the collateral properly insured, and are unlikely to consider any debtor excuse, if the collateral is uninsured.

Practice Tip #3: Do not ignore other matters that occur simultaneously during a bankruptcy case. Overlapping deadlines exist with respect to objecting to a plan, attending a 341 meeting, responding to an exemption claim or filing a proof of claim. One matter does not stay the other matters.

Practice Tip #4: Bankruptcy courts permit you to seek alternative relief. When seeking a Comfort Order, it is prudent to request the alternative relief of a lift from the stay, should your motion for a Comfort Order be denied.

Summary: If property is incorrectly listed as an asset of a bankruptcy estate or a question exists whether any property belongs to the debtor or is in the debtor's possession, consult an attorney and obtain a Comfort Order to protect yourself. A relatively inexpensive Comfort Order can potentially avoid significant litigation costs, attorney's fees and sanctions.

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