FIRST-DAY MOTIONS: PERILS AND POSSIBLE PITFALLS

AN OVERVIEW OF FIRST-DAY MOTIONS

Sanford R. Landress
Greene & Markley, P.C.

I.
INTRODUCTION TO FIRST-DAY MOTIONS

First-day motions are motions typically filed with or shortly after the debtor's petition in a Chapter 11 case. The purpose of such motions is to ease the debtor's transition into Chapter 11. They typically request approval to make immediate payments on some prepetition debts, seek approval of post-petition financing arrangements, and address important procedural issues such as the employment and payment of professionals. They may also go further, and seek the imposition of procedures deemed beneficial by the debtor but which may be detrimental to one or more creditor constituencies.

Viewed from a pro-debtor point of view, first-day motions help the debtor maintain relations with its employees, maintain beneficial relations with key vendors, efficiently manage its cash, and obtain necessary financing. Critics, however, argue that first-day motions can sometimes be abused to do much more than simply ease the debtor's transition into Chapter 11. Such motions, those critics say, can become a "goodie-bag" providing far-reaching relief to the debtor, creating procedures disadvantageous to disfavored creditors, granting unmerited advantages to powerful creditors, and in general tilting the playing field in ways not contemplated by the Bankruptcy Code itself. The battlefield is potentially complex, because the Bankruptcy Code sections cited as justification for some first-day orders do not explicitly allow the relief often requested. Moreover, courts across the country disagree as to which first-day motions are proper, which are improper, and the legal rationales distinguishing proper from improper first-day motions.

The first-day motions needed by particular debtors vary from case to case. Exactly what first-day motions are needed, and the nature of the relief requested in each such motion, is a major analytical task to be performed by the debtor's counsel early in the case. As will become clear, the number and complexity of possible first-day motions make this a difficult task to be performed at the last minute. Debtor's counsel should have familiarized himself or herself with the debtor's particular requirements well before commencing the case, and should have begun drafting first-day motions well before the actual first day of the case. If that has not been done, it is an understatement to say that the early days of the case will be particularly stressful for debtor's counsel.

Counsel must also recognize that first-day motions provide the earliest opportunity for the court to assess counsel, the competing creditors, the general case background, and the likelihood of a successful reorganization. For counsel, especially the debtor's counsel, candor, reasonableness, and good organization are particularly important. There may be strategic tension between the

desire to create a favorable environment for the debtor and important creditor constituencies, and the need to avoid an appearance of overreaching on the debtor's part.

Counsel for the debtor does, however, enjoy a considerable strategic advantage in first-day motion practice. Creditors may not expect a debtor to file for bankruptcy and may be ill-prepared to deal with it. Debtor's counsel, in contrast, should be ready and able to proceed quickly. As a result, the most common creditor strategy for opposing first-day motions is delay. Counsel for creditors often request additional time to respond or to take discovery, and often attempt to limit any relief granted to the minimum necessary for as short a time as possible. That gives them time to prepare a real opposition for the final hearing. Again, however, there is strategic tension between the desire to preserve a level playing field for creditors and the need to avoid the appearance of being a "spoiler" early in the case.

A. *Typical First-Day Motions***.**

First-day motions typically fall into three general categories: administrative motions, operational motions, and substantive motions. Typical examples of each of these three basic types of motions are as follows:

1. *Administrative Motions*:

   a. Motion for Order Directing Joint Administration of Related Bankruptcy Cases;

   b. Motion for Order Establishing Notice and Administrative Procedures;

   c. Motion for Order Extending Time to File Schedules, Statements of Financial Affairs and Certain Lists Required by Bankruptcy Rule 1007(c);

   d. Motion for Order Authorizing the Employment of Professionals; and

   e. Motion for Order Establishing Interim Fee Procedures.

2. *Operational Motions*:

   a. Motion for Order Approving Cash Management System (Bank Accounts/Business Forms);

   b. Motion for Order Authorizing Debtor to Pay Prepetition Claims of Critical Vendors;

   c. Motion for Order Authorizing Debtor to Honor Prepetition Employee Benefits and Pay Prepetition Priority Wage Claims;

d. Motion for Order Establishing Adequate Assurance of Payment for Utilities;

e. Motion for Order Authorizing Payment of Certain Prepetition Customer Claims in the Ordinary Course of Business (e.g., Gift Certificates, Layaway Claims, Warranty Claims, and Refund Policies);

f. Motion for Order Authorizing Payment of Potential Statutory Lienholders in Satisfaction of Liens; and

g. Motion for Order Permitting Debtor to Honor Workers' Compensation Programs and Pay Insurance Obligations.

3. *Substantive Motions*:

a. Motion for Order Authorizing Use of Cash Collateral;

b. Motion for Order Authorizing Postpetition Financing; and

c. Motion for Order Authorizing Rejection of Leases Effective as of the Petition Date.

B. *Procedural Issues*.

First-day motions present unique notice issues given the need to balance the due process rights of affected parties with the debtor's need for expedited relief and the practical difficulty of providing adequate notice very early in the case. Ultimately, the notice that should be given depends on the nature of the motion, the urgency of the requested relief, and local practice.

Notice requirements are generally governed by Bankruptcy Code § 102(1) and Bankruptcy Rule 2002. Bankruptcy Code § 102(1) embodies a flexible and pragmatic approach to notice. This provision defines the Code's term of art - "after notice and a hearing" - to require "such notice as is appropriate in the particular circumstances." This typically means that notice is provided to certain major players in the case, such as the U.S. Trustee, the principal secured creditors, the 20 largest unsecured creditors, and anyone specifically requesting notice. In addition, the parties directly affected by a request for relief must be given notice of the motion.

Attached is an example of a Request for Expedited Hearing on First-Day Motions. Also attached as an example is a form of Notice. Attached to the sample Notice as exhibit A is a list of the First-Day motions which happened to be involved in that particular case. That list will give you some idea of the potential complexity of the Omnibus Hearing on first-day matters. Typically, the best the debtor can expect are Interim Orders granting the requested relief for a short period of time. The court normally sets a final hearing within 15 to 30 days, and often requires the debtor to provide more extensive notice to a wider group of creditors before that final hearing. Final orders, if the debtor prevails, will be entered at that point.

II.
ADMINISTRATIVE MOTIONS

Administrative motions are intended to help the debtor and its professionals operate as efficiently as possible during the Chapter 11 case. Each of these motions could be the subject of a seminar topic. All that is attempted here is a survey of the typical administrative motions, along with citation to basic authorities.

A. *Motion for Order Directing Joint Administration of Related Bankruptcy Cases*.

When related entities file bankruptcy cases, motions filed in one case often apply to the other affiliated debtors. The purpose of a motion for order directing joint administration of related bankruptcy cases is to avoid unnecessary and expensive duplication caused by preparing (and serving) the same motion with different captions multiple times for each debtor. However, joint administration is not the same thing as substantive consolidation as it does not affect the substantive rights of any creditor. The assets and liabilities of each debtor remain separate. The estates are consolidated merely for procedural purposes. Bankruptcy Code § 302 and Bankruptcy Rule 1015(b) make clear that joint administration may be appropriate when two or more related debtor entities, whether spouses, partnerships, or corporations, have filed for protection under the Code.

B. *Motion for Order Establishing Notice and Administrative Procedures*.

In large or complex cases, the number of affected creditors and other interested parties can impose heavy administrative costs upon the debtor, the bankruptcy court, and the clerk's office. Accordingly, debtors often seek orders establishing case-specific notice and administrative procedures. For example, such orders may (i) provide procedures for filing papers and obtaining copies of pleadings from the bankruptcy court, (ii) authorize Internet postings of various pleadings, (iii) limit notice of certain motions and other matters, (iv) approve the form and manner of service of the Notice of Commencement of the Bankruptcy Case, or (v) appoint a claims-processing agent.

Bankruptcy Code § 102(1)(A) defines "after notice and a hearing" to mean "after such notice as is appropriate in the particular circumstances, and such opportunity for a hearing as is appropriate in the particular circumstances...." Further, Bankruptcy Code § 105(d) grants the court authority to "unless inconsistent with another provision of this title or with the applicable [Bankruptcy Rules], issue an order...prescribing such limitations and conditions as the court deems appropriate to ensure that the case is handled expeditiously and economically." Additionally, Bankruptcy Code § 105(a) provides that "the court may issue any order, process or judgment that is necessary or appropriate to carry out the provisions of this title."

Bankruptcy Rule 2002(i) and (m) and Bankruptcy Rule 9007 provide further authority for the notice procedures. However, Bankruptcy Rule 2002(a) states that, except as provided in Rule

2002(h), (i), and (l), notice of certain specified matters must be provided to the debtor, the trustee, all creditors and indenture trustees.

C. *Motion for Order Extending Time to File Schedules, Statements of Financial Affairs, and Certain Lists Required by Bankruptcy Rule 1007(c).*

This relief is commonly sought by a debtor where the size and complexity of the case and the number of creditors make it difficult, if not impossible, to prepare accurate schedules and an accurate statement of financial affairs within the time period prescribed by Bankruptcy Rule 1007(c). Moreover, other important tasks such as conducting an inventory of all assets and listing each of the debtor's executory contracts and unexpired leases often cannot be completed within the requisite 15 day time period. This relief may not be limited to large or complex cases. In fact, often the small unsophisticated debtor needs an extension of time just as much as a large debtor. Bankruptcy Rule 1007 allows the court, for cause, to extend the deadline for the debtor to file its schedules and statements, which the debtor must otherwise file within 15 days after the commencement of the case. Motions requesting such relief are generally noncontroversial and are granted *ex parte* without citing any case authority.

D. *Motion for Order Authorizing the Employment of Professionals*.

For bankruptcy lawyers and financial consultants, the most important first-day motion and order may be their application for employment. A debtor in possession may only retain professional help (*e.g.* attorneys, accountants, real estate brokers, investment bankers) to perform services on behalf of the bankruptcy estate with court approval. Each retention application should discuss the services to be provided by the proposed professional, the compensation to be paid to that professional and why the debtor believes that the professional is a "disinterested person," as that term is defined in Bankruptcy Code § 101(14).

Bankruptcy Code § 327(a) provides authority for the trustee to employ "attorneys, accountants, appraisers, auctioneers or other professional persons" who are "disinterested persons" and do not hold or represent an interest adverse to the estate to represent and assist the trustee in carrying out the trustee's duties under the Code. This authority to employ professional persons is extended to the DIP pursuant to Bankruptcy Code § 1107(a) and to official committees pursuant to § 1103(a).

Bankruptcy Rule 2014 requires any professional that will be employed to file an affidavit that establishes the professional's disinteredness and identifies all connections with the debtor, creditors, any party in interest, their respective attorneys and accountants, the U.S. Trustee or any person employed in the office of the U.S. Trustee.

E. *Motion for Order Establishing Interim Fee Procedures.*

As mentioned above, debtors routinely employ attorneys, accountants and other professionals subject to the provisions of the Code relating to employment and compensation of

professionals. Bankruptcy Code § 331 authorizes applications for interim compensation of such professionals once every 120 days unless the court permits them more frequently. Where cases warrant more frequent payments, the court may establish a procedure for monitoring and paying a percentage of fees (typically, 80 to 90 percent) and all expenses on a monthly basis. Formal interim fee applications are filed on a quarterly basis seeking approval of the interim payments and authority to satisfy any unpaid portion of the fees.

Reviewing professionals' compensation on a monthly basis (rather than every 120 days) gives debtors, committees appointed pursuant to the Code, the Office of the U.S. Trustee and other parties in interest a better position to monitor and control professional fees and costs on a current basis. Additionally, in cases where the professionals are required to devote substantial time, effort, money and expense to the debtors' cases, the absence of a procedure for paying interim compensation more often than every four months imposes undue financial burdens on the professionals, compels retained professionals to finance the Chapter 11 cases, and may discourage professionals from accepting or continuing employment in bankruptcy cases.

In enacting the professional compensation provisions of the Bankruptcy Code, Congress adopted the principle that "[p]rofessionals in bankruptcy cases are entitled to be paid on a comparable basis to other privately retained counsel, both in terms of timeliness and amount of payment." Congress, in enacting § 331, expressed unequivocally that when the situations warrant more frequent payment, the court should permit it. The leading case discussing these particular procedures is *U.S. Trustee v. Knudson Corp.* (*In re Knudson Corp.*), 84 BR 668 (9th Cir BAP 1988).

III.
OPERATIONAL MOTIONS

When Congress created the Bankruptcy Code during the 1970's, it unfortunately did not do enough to smooth the transition into bankruptcy. Many practical concerns went unaddressed. Some rules, such as the seemingly absolute prohibition on paying prepetition claims except under a plan, proved to be unworkable in some situations. Operational motions are typically designed to address such matters. Again, each of these motions could be the subject of a seminar topic. The goal today is simply to provide a survey of some typical operational motions.

A. *Motion for Order Approving Cash-Management System.*

Operating guidelines for most Chapter 11 cases require, among other things, that the debtor close pre-petition bank accounts, establish new DIP accounts, and maintain separate DIP bank accounts for cash collateral and tax obligations. In addition, all checks used by the debtor postpetition typically must have the designation "debtor-in-possession" or "DIP" on them. In complex cases, the benefits such guidelines provide may be outweighed by the disruption they cause. Hence, courts will sometimes (if absolutely necessary) enter orders approving the continued use of the debtor's pre-existing cash-management system. Bankruptcy Code § 363(b)(1) provides the authority for such orders.

B. *Motion for Order Authorizing Debtor to Pay Prepetition Claims of Critical Vendors.*

The debtor's ability to operate its business during a Chapter 11 case often turns on the willingness of suppliers to continue providing goods and services postpetition. In most cases, the debtor's primary vendors will hold unsecured claims for unpaid goods and services provided prepetition. Additionally, pursuant to Bankruptcy Code § 503(b)(9), goods received in the ordinary course within 20 days of filing can often be reclaimed from the debtor. If the debtor is unable to retain the goods or maintain a flow of goods and services from its suppliers, the Chapter 11 debtor could be crippled. Accordingly, debtors sometimes request authorization to pay the prepetition claims of the most important vendors.

This can be a controversial motion. The debtor is asking for permission to favor some creditors with prompt payment, while making less-favored creditors wait for several months for payment under a plan. Bankruptcy courts tend to view such requests with great skepticism. Previously, these motions were based solely on Bankruptcy Code § 105(a)'s authorization for the court to issue any order necessary to carry out the provisions of the Code. The court in *In re Kmart Corp.*, 359 F3d 866, 871 (7th Cir 2004), however, disputed the notion that this provision alone can be a basis for paying prepetition claims. Nevertheless, bankruptcy courts continue to grant such motions on occasion. Some courts do so under something they call the "doctrine of necessity." *But see B&N Enterprises, Inc. v. Goodman Oil Company (In re B&W Enterprises, Inc.)*, 713 F.2d 534 (9th Cir. 1983) (rejecting that doctrine).

C. *Motion for Order Authorizing Debtor to Honor Prepetition Employee Benefits and Pay Prepetition Priority Wage Claims.*

Upon filing, the debtor no longer has any authority to pay its prepetition employee wages and benefits except under a plan. Accordingly, absent an order authorizing the debtor to pay prepetition wages and benefits, the Chapter 11 debtor's employees may quit and its business may not be able to continue to operate. Courts therefore typically allow such motions, at least up to the amount such claims would have priority. A debtor can rely on the employee wage priority provisions of Bankruptcy Code § 507(a)(4) and (5) as support for the motion. Additionally, debtors rely on Bankruptcy Code §§ 105(a), 363, and 1108.

D. *Motion for Order Establishing Adequate Assurance of Payment for Utilities.*

A debtor typically must maintain utility services, including basic electricity, phone, water and sewer service, in order to operate its business. Under Bankruptcy Code § 366, a Chapter 11 debtor, within 30 days after filing, must post an assurance of payment with each utility provider. The debtor must seek court approval for this action. Bankruptcy Code §§ 366(b) and 366(c)(3) allow a court, on the request of a party in interest, which includes a debtor and a utility provider, to order a "reasonable modification of the amount of deposit or other security necessary to provide adequate assurance of payment."

In determining whether an assurance of payment is adequate, the court is not required to

give a utility the equivalent of a guaranty of payment. Instead, it must determine only that the utility is not subject to an unreasonable risk of non-payment for postpetition services. *In re Caldor, Inc.-NY*, 199 BR 1 (SDNY 1996); *In re Santa Clara Circuits West, Inc.*, 27 BR 680, 685 (Bankr. D. Utah 1982); *In re George C. Frye Co.*, 7 BR 856 (Bankr. D. Me. 1980).

E. *Motion for Order Authorizing Continuation of Customer Programs and Payment of Certain Prepetition Claims in the Ordinary Course of Business.*

For most Chapter 11 debtors, their customers are the lifeline that will determine whether their reorganization is successful. However, without court approval, the debtor will not be able to honor its prepetition customer loyalty programs including warranty service, gift certificates, or layaway sales. These motions are generally based on Bankruptcy Code § 105. Debtors also may be able to rely on Bankruptcy Code §§ 363 and 1108 as authority for continuing such programs. *See also In re Kimball Hill, Inc., et al*, Case No. 08-10095 (Bankr. N.D. Ill. 2008). This may be considered to be a decision to enter into a transaction outside of the ordinary course of business. If so, a debtor's decision to enter into a transaction outside of the ordinary cause of business is governed by the business judgment standard. *Fulton State Bank v. Schipper*, 933 F.2d 513, 515 (7th Cir. 1991).

F. *Motion for Order Authorizing Payment of Contractors in Satisfaction of Liens.*

Debtors, especially developers, often require services in construction projects. If these construction projects are ongoing at the time of filing, or the contractors have not been paid yet, the contractors may assert liens against the debtor's property. Accordingly, debtors may wish to pay these claims to prevent the creation of such liens. This motion is based generally on Bankruptcy Code § 105. Also relevant are Bankruptcy Code §§ 362(b)(3) (excluding the act of perfecting a construction lien from the automatic stay), 363(b)(1) (allowing the debtor to use, sell or lease, other than in the ordinary course of business, property of the estate), and 502(b) (allowing payment to fully secured creditors). Bankruptcy courts have recognized that such relief is appropriate for large homebuilders in bankruptcy. *See In re Kimball Hill, Inc., et al*, Case No. 08-10928 (Bankr. N.D. Ill. 2008); *In re TOUSA, Inc.*, Case No. 08-10928 (Bankr. S.D. Fla. 2008).

G. *Motion for Order Permitting the Debtor to Honor Workers' Compensation Programs and Pay Insurance Obligations.*

State and federal law often requires companies to establish and maintain a workers' compensation program and various types of related insurance. Additionally, the guidelines of the U.S. Trustee require the continuation of certain insurance programs in bankruptcy. Finally, failure to maintain appropriate insurance that poses a risk to the estate or to the public is cause for mandatory conversion or dismissal of a Chapter 11 case under Bankruptcy Code § 1112. Accordingly debtors often move to make payments necessary to continue these programs and insurance.

This motion is based generally on Bankruptcy Code § 105. In certain cases, the coverage may be required by the U.S. Trustee. Moreover, under 28 USC § 959, the debtor-in-possession is required to comply with nonbankruptcy law. Finally, the debtor may argue that payment of premiums is in the ordinary course of business under § 363(c)(1) because the debtor is operating the business pursuant to Bankruptcy Code §§ 1107(a) and 1108.

IV.
SUBSTANTIVE MOTIONS

Substantive first-day motions are often the most critical first-day motions. They typically involve vital motions seeking approval of the debtor's use of cash collateral. In most cases, most or all of the debtor's cash will be some lender's cash collateral. This term of art is defined in 11 USC § 363(a). Under 11 USC § 363(c)(2), the debtor cannot use cash collateral unless the creditor consents or the court, after notice and a hearing, authorizes such use. Smart debtors will have negotiated stipulated orders with the necessary creditors in advance. If such negotiations fail, the debtor must obtain bankruptcy court approval before it can use cash collateral. If it fails to do so, that can be the end of the case. As a result, these particular first-day motions often become the major focus of debtor's counsel.

A. *Motion for Order Authorizing Use of Cash Collateral*.

Bankruptcy Code § 363(c)(2) permits a debtor to use cash collateral if each entity that has an interest in the cash collateral consents, or the court authorizes such use. The court will only authorize the use of the cash collateral over the objection of the secured party if the debtor has provided "adequate protection" of the secured creditor's interest in the cash collateral. 11 USC § 363(e). The debtor must also comply with Bankruptcy Rules 4001(b) and 9014.

The creditor bears the burden of proving the validity, priority, and extent of its claimed interest. 11 USC § 363(p)(2). *See also Chequers Investment Associates v. Hotel Sierra Vista Limited Partnership (in re Hotel Sierra Vista Ltd. Partnership)*, 112 F.3d 429, 434 (9th Cir. 1997). The debtor bears the burden of proving that the creditor's interest is adequately protected. 11 USC §363(p)(1). Adequate protection is provided to safeguard the creditor only against depreciation in the value of its collateral during the reorganization process. *First Federal Bank of California v. Weinstein (In re Weinstein)*, 227 BR 284, 296 (9th Cir. BAP 1998). It is not intended to compensate the creditor for lost interest or for lost opportunity cost, nor to perpetuate the existing ratio of collateral to debt. *Id.* *See also Orix Credit Alliance, Inc. v. Delta Resources, Inc. (In re Delta Resources, Inc.)*, 54 F.3d 722, 730 (11th Cir. 1995). As a consequence, where there is no depreciation there is no entitlement to adequate protection. *Weinstein*, 227 BR at 296.

B. *Motion for Order Authorizing Postpetition Financing*.

These types of motions are sometimes used as an alternative to motions for orders authorizing the use of cash collateral. Bankruptcy Code § 364 authorizes postpetition financing as follows: (1) no approval is necessary for unsecured credit obtained in the ordinary course of

business (2) the court may approve nonordinary course unsecured credit or obtaining credit by giving the lender superpriority status, and (3) if the debtor cannot otherwise obtain needed credit, the court may authorize the debtor to incur credit on a secured basis. Bankruptcy Rule 4001(c)(1), (2), and (3) govern the notice-and-hearing requirement for these motions.

C. *Motion for Order Authorizing the Rejection of Nonresidential Real Property Leases*.

In certain circumstances, if a debtor has numerous leasehold interests that are not going to be used in the continuing operations, the debtor may wish to reject such leases immediately to avoid priority administrative expense claims for rent. A debtor may decide to file a motion to reject and terminate an unexpired lease pursuant to Bankruptcy Code § 365(a) as a first-day motion in some cases.

In deciding whether to approve a debtor's decision to reject an unexpired lease, a bankruptcy court should ordinarily defer to the debtor's business judgment where that business judgment is exercised in good faith. *Agarwal v. Pomona Valley Medical Croup, Inc. (In re Pomona Valley Medical Group, Inc.)*, 476 F.3d 665, 669-70 (9th Cir. 2007).

V.
CONCLUSION

Most first-day motions will not be cause for serious litigation. Typically, the debtor's counsel is proposing nothing more than a series of orders easing the debtor's orderly transition into the Chapter 11 environment. Creditors' counsel must, however, remain alert for those cases where the debtor seeks to overreach. Without quick action, some creditor groups can find that the playing field has been quickly tilted against them at the very outset of the case in ways that can ultimately affect who gets paid what throughout the entire case and even under the eventual plan.