A “Short” Course on Bankruptcy Law

Syracuse University
Distress Investing Seminar

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I. Overview and Assignment

The world economies were booming after the 2007 financial crisis ended in 2010. Fueled by low interest rates and easy money, consumers have been consuming and spending as never before, businesses have been borrowing at low interest rates and expanding, and both real estate and financial markets were rising at a fast clip. Unemployment dropped from 10% in 2010 to a little over 3% in January 2020.

Then the Covid virus hit the world like a meteor from outer space. Business activity has been in free-fall since the lockdown, and no one knows what the future holds. While financial markets have been rising over the past few weeks in anticipation that the economy will reopen soon, there is substantial doubt about how fast we will recover from the shock. I believe that there will be a long and painful recovery – unemployment will be high, consumers will not be able to make their rent and debt payments, savings rates will rise among those concerned about the future, consumers will cut back on spending and will remain in fear of public activities, corporations will cut back on capital spending to pay down debt, and many businesses will fail. Entire industries – airlines, hotels, shopping centers, restaurants - will have a very difficult time recovering. You will be learning in this class a topic – distress investing - that may prove to have been extremely timely.

What is distress investing? Some investors may have made loans or equity investments in strong companies only to see those companies (and their investments) fall on hard times. Other investors are interested in making an initial investment to a troubled company (or buying out fair-weather investors at a substantial discount). Investors need to understand the intrinsic value of their investment, and that intrinsic value depends on the legal rights accorded to the investment.

In this class, we will look at the legal rights of the investors and the company in times of distress.

In Monday's class, we will look at the basic principles of bankruptcy law. Read Pages 1 to 23 before class and think about the problems. We will cover the problems in class.

In Tuesday's class, we will apply those principles to the reorganization of a business in Chapter 11 of the Bankruptcy Code. Read pages 24 to the end before class.

I. The Capital Structure of a Business

The capital structure of a business consists of the legal interests that creditors and equity security holders own. There are two basic categories of legal interests: (1) debt, and (2) equity. Debt obligations must be paid in accordance with the terms of the debt instrument or the issuer will be in default. Upon default, the holder can take legal action to collect the debt from the business's assets. There are many kinds of debt obligations. Ordinary trade creditors will hold general claims against the company. The company may have borrowed money privately by signing promissory notes. The company may have issued public bonds or indentures that were sold to investors. Each of these creditors will have legal rights accorded by their contract with the company.

Equity represents the ownership of the company. Equity owners have no contractual rights to payment – equity owners receive dividends at the discretion of the company, and have a right to participate in liquidation distributions in accordance with their contractual rights. Equity holders may vote to change management or liquidate, but they cannot cause the company to default because they have no contractual rights to demand payment. The precipitating cause of business failure is the failure or inability of the company to pay its contractual debts on time. We will begin our study of distress investing by looking at the rights of creditors upon the company's default.

II. Collecting Debts Outside of Bankruptcy

An **unsecured claim** arises from a debtor's legal obligation to pay money or property to a creditor. The legal obligation can be created by a debtor's promise to pay money or deliver property to a creditor (contract), from a debtor's receipt of money or property under circumstances requiring restitution (quasi-contract), or from a debtor's commission of a tort (a legally wrongful act, such as negligence or an intentional tort like battery).

A **secured claim** arises when the debtor voluntarily gives a lien on some or all of the debtor's property to secure repayment of the debt (consensual lien), or when the law imposes a lien on debtor's property to secure repayment of the debt (involuntary lien). A lien is a legal right "*in rem*" that the creditor has to specific property owned by the debtor. A lien is an interest in the property itself, and must be distinguished from the **unsecured** "*in personam*" right that the creditor has against the person of the debtor. We will start with a review of the **system for collecting unsecured**

claims based on the debtor's promise or legal obligation to pay, and then we will look at the creation, enforcement and priority of secured claims.

III. Collecting Unsecured Claims

A. Self Help

There are two ways to collect claims: (1) using **self-help**, and (2) using the **judicial system**. At one time creditors were permitted to use violence and enslavement to collect their claims. In medieval times, the law even assisted creditors by allowing pillory, under which debtors were restrained and subjected to maiming or death at the hands of their creditors. That is no longer the case. It is a crime in every state to threaten or use violence to collect debts.

Short of violence and threats of violence, however, the state laws on debt collection are ill defined and poorly enforced. Creditors are generally free to call or visit their debtors to ask for payment, to report defaults to credit bureaus (which can result in the modern equivalent of a scarlet letter), and even engage in various forms of conduct that many would consider to be harassment.

The legal limitations on self-help are generally embodied in criminal laws like extortion, although some states have enacted special statutes detailing unfair debt collection practices by creditors. Most of these state law statutes are modeled after the federal *Fair Debt Collection Practices Act* (the "FDCPA"), which applies only to third party debt collectors. The state statutes often extends the FDCPA to creditors themselves. There are also general consumer protection statutes that protect debtors from unfair collection practices, but these tend to apply only to specific industries and practices.

B. The Limits of Self Help

While creditors can often harass and coerce debtors into voluntarily paying their debts, that's generally as far as they can go. **Unsecured creditors cannot use self-help to recover and sell the debtor's property**. If unsecured creditors cannot obtain voluntary repayment, they must resort to the legal system to collect debts.

C. Judicial Enforcement of Unsecured Claims

The legal system provides the main remedy for unsecured creditors who cannot obtain payment voluntarily. First, the creditor must file a lawsuit against the debtor. Second, the creditor must win the lawsuit (often by default because the debtor does not file an answer with the court). Third, the winning creditor must obtain a **money judgment** from the court. Fourth, the creditor must obtain from the clerk of the court a **writ of execution** identifying property owned by the debtor that is available for execution. Firth, the creditor must deliver the writ of execution to the levying officer (normally the County Sheriff) with instructions to levy on the property. Sixth, the Sheriff must retrieve the property (using force if necessary) from the judgment debtor. Seventh, the Sheriff must sell the property in accordance with the State's statutory sale rules. Finally, the proceeds of the sale are applied to repay the Sheriff's costs, then the claims of creditors, with the balance if any returned to the debtor.

In the great majority of consumer cases the process for obtaining a judgment is simple because the debtor does not file an answer to the complaint. The process for filing suit and taking a default judgement when the debtor does not answer the complaint takes less than two months and is quite mechanical. For most debts, the clerk will enter the default judgment without any evidentiary showing by the creditor.

However, if the debtor files an answer to the complaint, the mechanical process will come to a screeching halt. If an answer is filed, the creditors will have to prove their case, either at trial or by summary judgment if there are no genuine issues of fact in dispute. A savvy debtor can often delay the process of obtaining a judgment for years. If the debtor answers the complaint, collection firms will often dismiss or let the case languish rather than seeking a judgment because the cost and difficulty of proving the case exceeds its value. For large business debts, the debtor will likely answer the complaint, and the creditor will have to prove that it is entitled to a judgment – a process that will often take years. Lawyers creditors collecting consumer debts rely on the debtor's failing to file an answer.

After the creditor obtains a judgment, either by default, after summary judgement, or after trial, the creditor will need to locate non-exempt property owned by the judgment debtor that is available for execution. Individual debtors are entitled to state-law **exemptions** to protect things like household items, cars up to certain values, and a homestead. Business debtors are not entitled to exemptions, but the creditor must still find property owned by the judgment debtor that is worth levying on and selling. The judgement creditor can examine the judgement debtor under oath, or serve a questionnaire that must be answered under oath, to attempt to locate property available for execution.

After receiving a writ of execution and instructions from the judgement creditor, the levying officer will drive to the location of the property, physically seize the property (this is called a "levy"), bring the property back to the levying officer's place of business, and proceed to follow a statutory procedure for selling the property (normally through an advertised auction process).

The process for levy is slightly different for real property, since the levying officer cannot put land in the back of a pickup truck. The levy on real property is generally made by the levying officer posting some sort of notice that the land is being seized. Some states require other symbolic acts by the levying officer, such as grabbing some soil and saying a magic incantation in addition to posting the notice of levy. Following levy, the property can be sold by the levying officer in accordance with a statutory sale procedure.

If there are no secured claims against the property levied upon, the proceeds from the levying officer's sale are used first to pay the levying officer's fees and costs, second to pay the creditor's judgment, and any balance is given to the debtor.

D. Garnishment and Judicial Liens

There are two important offshoots of the levying process. The first is garnishment. Garnishment is a procedure by which a creditor seeks to recover property owing by a third party to the judgement debtor. For example, if the judgement debtor has money in a bank account (the bank owes money to the judgement debtor), the creditor can garnish the bank and obtain the money. Wage and bank account garnishments are the primary methods of collecting money judgments from consumer debtors.

The second offshoot is the judicial lien on real property; a process much less expensive for the creditor than levy and sale. Although some state laws give judgment creditors an automatic lien on real property (generally on property owned by the debtor in the county where the judgment is entered), more commonly state laws require the creditor to record some evidence of the judgment in the county real estate records to create a judgment lien. Judgment liens last a long time, and usually prevent the debtor from selling the property without paying the lien.

E. The Race to the Courthouse

The process of execution results in a race to the courthouse by creditors. If the debtor has more than one creditor and insufficient assets to pay them all (we call this being “insolvent”), the creditors must compete with each other to recover. The first creditor to obtain a judgment and cause the levying officer to levy against the debtor’s property gets paid first out of the proceeds from the sale of that property. Slow creditors do not get paid at all. The system forces creditors to rush to recover from the debtor’s assets - to be the first to get a judgment and levy on the judgement debtor’s property. Outside of bankruptcy, it is the law of the jungle - survival of the fittest - with creditors rushing to be the first to recover a judgement and levy.

F. Bankruptcy as Collective Creditor Action

The process of bankruptcy began by creditors recognizing their mutual interest in avoiding the race to the courthouse. Instead of creditors competing with each other and often forcing quick sales of the debtor’s property for low prices, bankruptcy enabled creditors to join together in a proceeding to obtain the orderly sale of the debtor’s property for the highest price, and the distribution of sale proceeds to all creditors proportionally. The historical process of bankruptcy was a method for collective action by creditors. Originally, only creditors could initiate the bankruptcy process (today known as an “involuntary petition”), and only creditors received a benefit from the bankruptcy process. Later, cooperative debtors with the consent of their creditors could receive a **discharge from debtor’s prison**, but remained personally liable for any unpaid debts. Today, involuntary petitions are extremely rare because the filing creditors face significant liabilities if the involuntary petition is dismissed by the bankruptcy court.

The concept of a **discharge of debts** developed in the 19th Century, turning the process of bankruptcy from a method for joint creditor action into the voluntary process for debtors to obtain relief from the burden of excessive debt. Today, bankruptcy is almost entirely a voluntary system for debtors to obtain a discharge of their debts or to reorganize their businesses.

IV. Creating and Collecting Secured Claims

A secured claim is an “*in rem*” right against property – the property itself is liable for the debt. The most common type of secured claim is created by the debtor voluntarily granting to a lender a lien on the property. A **mortgage** or deed of trust is used to grant a consensual lien on real property, and a **security agreement** is used to grant a consensual lien on personal property. These documents identify the property, and contain language by which the owner/debtor grants to the creditor a lien on the property to secure repayment of the debt. If the debt is not paid, the creditor can resort to the collateral for payment by foreclosing the debtor’s **equity of**

redemption – the right to pay off the loan and free the property from the lien.

Secured claims can also be created by **judicial action** (the process of levy, discussed earlier, creates a judicial lien) and by **statute** for certain favored creditors (the most common statutory lien is a mechanics lien given to a unpaid creditor who improves the debtor's property).

A. Priority of Secured Claims

Competing secured creditors are paid according to the priority of their liens. Senior priority liens are paid in full before junior priority liens receive any money from the sale of the property. The rules on priority vary by state and by the type of property and lien in issue. However, state priority rules contain many similarities. There is always a method of "perfection" by which the secured creditor gives notice to the world that the creditor claims a lien on the property, usually by recording a document (with the secretary of state for personal property and in the county real estate records for real property) that can be searched by a buyer or later secured creditor. Anyone buying, or obtaining a lien on, the property after the recording takes "subject to" the lien under a principle known as "constructive notice."

Personal property liens are governed by Article 9 of the Uniform Commercial Code ("UCC"), which has been enacted (with some variation) in every state, and therefore provides a uniform method for creating and enforcing liens on personal property.

A lien on personal property is created (called "attachment") when **all** of the following **three events** occur: (1) the debtor signs a security agreement granting a lien to the creditor, (2) the creditor gives value, and (3) the debtor has rights in the collateral. A security interest that has attached can be enforced by the creditor against the debtor, but an attached lien does not protect the secured creditor against later buyers or other secured creditors.

In order for a creditor to preserve the priority of its lien against later buyers or other secured creditors, the creditor's security interest must be **perfected**, generally by filing a form called a financing statement or UCC-1 with the secretary of the state of the debtor's residence. The general rule for priority under the UCC between perfected secured creditors is the "first to file or perfect rule."

Real property liens are governed by state recording statutes. Once a mortgage or deed of trust is properly recorded, the creditor's lien against the property is perfected against later buyers or creditors.

B. Collecting Secured Claims

The law gives secured creditors expedited procedures for collecting their debts. For personal property, if authorized by the security agreement, a secured creditor can use **self-help to repossess and sell the collateral** in a commercially reasonable sale. Creditors using self-help cannot breach the peace, but in most states may use trickery to repossess property. Middle of the night car repossessions are common. If the collateral cannot be obtained without breach of the peace, creditors can use expedited judicial procedures to obtain a writ of possession from the court authorizing the levying officer to seize and sell the property. These expedited procedures (known by names such as replevin and claim & delivery in various states) are much faster than obtaining a judgment, finding non-exempt assets, and levying a writ of execution.

For real property, some states like California have non-judicial sale procedures by which real property liens can be foreclosed without court involvement. Other states like New York require a lengthy judicial process for foreclosing real property liens.

Unsecured creditors are always subordinate to secured creditors with respect to the collateral. But if the secured creditor's collateral is insufficient to repay the debt, the secured creditor has an unsecured claim for the **deficiency** and must resort to the unsecured creditor collection procedures to obtain payment.

V. Out of Court Workouts

Suppose that the company is unable to make an upcoming payment that is due to creditors. The company needs more time to pay. The key problem in out of court workouts is obtaining the necessary creditor agreements to a modification of the creditors' contractual rights. There are other legal impediments to restructuring debts outside of bankruptcy. The federal **Trust Indenture Act** prohibits any modification to the **core** payment terms of a bond or indenture without the consent of every single bondholder. If even one bondholder refuses to grant an extension, the company will be in default. If there are only a few bondholders who own all the bonds, it may be possible to obtain an agreement. But if there are many bondholders, as is the case with most large public companies, it may not be feasible to obtain unanimous consent for a payment extension.

One possible method when most bondholders are willing to restructure but a few are not is to exchange the bonds of willing participants for new bonds calling for later payment. The company will still have to make the regular payments to the non-exchanging bondholders or be in default, but by getting more time from the willing participants a default may be avoided. What can the company do to encourage bondholders to consent to an exchange offer?

The Trust Indenture Act only prohibits modification of core payment terms without the consent of each bondholder. It does not prohibit the modification of other non-core terms. "Non-core" terms can be modified in accordance with the contractual voting provisions of the bond. The bond may say, for example, that if 80% of the bondholders agree to modify a non-core term, then only the votes of 80% are needed to change that term. Let's look at a coercive exchange offer designed to "encourage" bondholders to agree to exchange their bonds.

QUESTION 1

Debtor has $10 million face value of debentures outstanding. Because of the debtor's serious financial problems, the debentures are selling for 50% of face value on the open market. The bonds prevent the debtor from granting a security interest in the company's assets to anyone (this is known as a "negative pledge"). However, the indenture for the debentures provides that covenants such as the negative pledge can be waived with the consent of 70% of the bondholders. The Debtor wants to restructure the bonds, but cannot reduce the payment terms without the consent of each bondholder, and the Debtor knows there will be holdouts. The debtor makes the following proposal:

1. **Debtor offers to exchange the old bonds at 65% of face value for new bonds secured by the assets of the company.**
2. **Anyone participating in the exchange must consent to the waiver of the negative pledge for the old bonds. This is known as an "exit consent."**
3. **The market value of the old bonds will fall dramatically without the negative pledge, because the secured claims will come ahead of the old bonds in a liquidation of the company.**
4. **The bondholders object, arguing that the exchange offer is "coercive" and "unfair," because they are being forced by the threat of subordination to exchange in order to protect the**

value of their bonds, which they say is the equivalent of a change in the terms of payment without unanimous consent.

The Delaware court in *Katz v. Oak Industries*, 508 A.2d 873 (Del.Ch. 1986), allowed the use of exit consents such as this in exchange offers, and rejected the notion that debtors could not use coercive exchange offers in bond transactions. The court held that the debtor owes no fiduciary duties to bondholders or other creditors, and that the debtor's only obligations are contractual. The Debtor cannot change the terms of the old bonds, but may be able to use the contractual provisions in the bond indentures to coerce the old bondholders to exchange.

After *Katz v. Oak Industries*, someone buying a bond must consider whether the contractual rights in the bond indenture will protect against being coerced by an exit consent to tendering into an exchange offer that will impair the right to payment. What percentage of votes is required by the indenture to waive covenants? It becomes a prisoner's dilemma.

VI. Overview of the Bankruptcy Process

Unlike the race to the courthouse, Bankruptcy offers the distinct advantage of organization, time, and fairness among creditors. It also offers individual debtors the benefit of a fresh start through discharge, and gives business debtors the opportunity to reorganize rather than being dismembered by creditor levies and sales.

A. Organization of the Bankruptcy Code

The entire bankruptcy code is **Title 11** of the United States Code. Do not confuse Title 11 with Chapter 11, which is one of the Chapters in Title 11.

Chapters 1, 3 and 5 apply to **all** the chapter proceedings. These chapters contain basic rules regarding the duties and benefits to parties in bankruptcy.

Chapters 7 and 11 are the main business chapter proceedings – the rules of each chapter only apply to cases filed under that chapter. We will be focusing on these two chapters.

There is also a Chapter 9 for municipalities, Chapter 12 for small farmers and fisherman, Chapter 13 for individuals with regular income who have modest debts, and Chapter 15 for foreign entities who have filed for bankruptcy protection in another country but have assets that need to be administered in the United States. We will focus on Chapters 7 and 11.

B. Chapter 7 of the Bankruptcy Code: Straight Bankruptcy

Chapter 7 is available to both individuals and business entities, such as corporations, partnerships, limited liability companies and the like. However, banks and insurance companies cannot file Chapter 7 – they are regulated by the federal and state governments, respectively.

In addition, consumer debtors have to meet a “means test” in order to avoid having their bankruptcy cases dismissed. The means test, enacted in 2005, contains a complex formula. However, debtors who have annualized gross income during the six full months before the filing date **below the median income in their state** for their family size satisfy the test. The complex formula only applies to those who have gross income exceeding the state median. The means test is not applicable to business entities or individuals who have primarily business debts.

a. Property of the Estate

All of the debtor’s assets on the date the bankruptcy become “property of the bankruptcy estate” and are legally owned by the bankruptcy trustee.

i. Exemptions

An **individual** debtor is allowed to take back from the estate, and keep, certain “exempt” assets. Exemptions are important for consumer debtors, but not important for business debtors. Most states exempt consumer goods, equity in cars up to certain values, and equity in a home up to certain values stated in the exemption statute.

ii. Secured and Unsecured Creditors

An **<u>under</u>secured creditor** is a creditor with a lien against property that has a value less than the debt. For example, a creditor who is owed $1 million and has a mortgage against the debtor’s house that is only worth $600,000 is an under-secured creditor. If the collateral were sold and the proceeds applied to the loan, the creditor would have an unsecured **deficiency** claim against the debtor for $400,000.

An **<u>over</u>secured** creditor has a lien against property that is worth more than the debt. For example, a creditor who is owed $600,000 and has a mortgage against the debtor’s house that is worth $1 million is an oversecured creditor, because the collateral is worth more than the debt. The oversecured creditor will be paid in full from the sale of the property.

iii. Recourse and Non-Recourse Secured Creditors

A secured loan can be made either **with or without recourse**. A loan made **with recourse** means that the debtor is personally liable for a deficiency judgment if the proceeds from the sale of the collateral are insufficient to pay the full debt. In the above example of a $1 million debt secured by property worth $600,000, the creditor could collect the $400,000 deficiency from the debtor's other assets as an unsecured creditor if the loan was made **with recourse**. On the other hand, if the loan was made **without recourse**, then the lender could only recover from the collateral and could not pursue a deficiency judgment. The non-recourse lender would have to write off the $400,000 deficiency as a loss.

iv. The Section 506(a) Split

Section 506(a) of the Bankruptcy Code splits the claim of an undersecured creditor into two claims: Here is the provision:

> *11 U.S.C. § 506(a)(1). An allowed claim of a creditor secured by a lien on property in which the estate has an interest . . . is a* ***secured claim to the extent*** *of the value of such creditor's interest in the estate's interest in such property, . . .* ***and is an unsecured claim to the extent*** *that the value of such creditor's interest . . . is less than the amount of such allowed claim. Such value shall be determined in light of the* ***purpose of the valuation and of the proposed disposition or use of such property****, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest.*

Thus, the creditor with a $1 million claim secured by property worth $600,000 will have a **$600,000 secured claim** and a **$400,000 unsecured claim** in bankruptcy. This is important in Chapter 7 because the secured claim will likely be paid in full upon the sale of the collateral, since the proceeds of any sale must first be applied to pay the secured claims against the collateral. The unsecured deficiency claim, however, may receive a small distribution along with other unsecured creditors. As we will discuss later, it is also important in Chapter 11 cases, where the cramdown requirements are different for secured and unsecured claims.

v. Unsecured Claims

The definition of a "claim" in the Bankruptcy Code is extremely broad.

> *11 U.S.C. § 101(5). The term "claim" means—*
>
> *(A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured,*

unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or

The bankruptcy court must determine the amount of claims **as of the bankruptcy petition date**. Claims that are unliquidated, unmatured or contingent must be estimated by the court.

11 U.S.C. § 502

(a). A claim or interest, proof of which is filed . . . is deemed allowed, unless a party in interest, including a creditor of a general partner in a partnership that is a debtor in a case under chapter 7 of this title, objects.

(b) . . . [I]f such objection to a claim is made, the court, after notice and a hearing, shall determine the amount of such claim in lawful currency of the United States as of the date of the filing of the petition, and shall allow such claim in such amount, except to the extent that—

(1) such claim is unenforceable against the debtor and property of the debtor, under any agreement or applicable law for a reason other than because such claim is contingent or unmatured;

*(2**) such claim is for unmatured interest**;*

[many other special claim limitations, including limitations on claims for future damages for breach of a lease or an employment agreement, are contained in the Bankruptcy Code.]

It is important to note that the claim amount is determined **as of the petition date**, and all interest stops accruing, except in two circumstances. The main one is 506(b):

*11 U.S.C. § 506(b). To the extent that an **allowed secured claim is secured by property the value of which . . . is greater than the amount of such claim**, there shall be allowed to the holder of such claim, **interest on such claim**, and any reasonable fees, costs, or charges provided for under the agreement or State statute under which such claim arose.*

Second, in the unusual case where a debtor is solvent – value of assets exceeds debts –the debtor must pay post-petition interest at the legal rate on all unsecured claims before any distribution is made to the debtor (equity holders). 11 U.S.C. § 726(a)(5).

QUESTION 2

Tablets-R-US, Inc. ("TRU"), is a New York corporation that manufactures Android computer tablets. In order to finance its operations, TRU borrowed $1 million from EasyLoan Bank, and signed a promissory note (agreeing to pay interest of 10% per year) and a security agreement giving EasyLoan a security interest (lien) on all of its inventory. At the time of bankruptcy, the inventory is worth $650,000 and EasyLoan is owed $1 million in principal and $25,000 in interest. What claims will EasyLoan have in TRU's bankruptcy proceeding? Can EasyLoan recover post-bankruptcy interest?

vi. The Automatic Stay

The automatic stay is fundamental to the bankruptcy process. Upon the filing of bankruptcy, creditors are automatically prohibited from taking any actions to collect the debt, including bringing or proceeding with lawsuits, repossessing property, sending demand letters, or otherwise taking "any act" to try to collect their debts. A violation of the stay is a contempt of court. Intentional violations are punishable by actual and punitive damage awards, together with an obligation to pay the debtor's attorney fees.

vii. Relief from the Automatic Stay

Secured creditors want to realize on the value of their collateral as soon as possible, but are prevented by the automatic stay from repossessing and selling their collateral during the pendency of the bankruptcy case. Because secured creditor have a property interests that cannot constitutionally be taken without due process, the Bankruptcy Code contains a provision for creditors to request relief from the automatic stay when the continuance of the automatic stay would cause the secured creditor to incur a loss, or when the continuation of the stay would not serve a proper bankruptcy purpose.

*11 U.S.C. § 362(d). On request of a party in interest and after notice and a hearing, **the court shall grant relief from the stay** provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay—*

> *(1) for cause, including the lack of adequate protection of an interest in property of such party in interest;* ***[OR]***
>
> *(2) with respect to a stay of an act against property under subsection (a) of this section, if—*
>
> > *(A) the debtor does not have an equity in such property; and*
> >
> > *(B) such property is not necessary to an effective reorganization;*

11 U.S.C. § 362(g). In any hearing under subsection (d) or (e) of this section concerning relief from the stay of any act under subsection (a) of this section—

> *(1) the party requesting such relief has the burden of proof on the issue of the debtor's equity in property; and*
>
> *(2) the party opposing such relief has the burden of proof on all other issues.*

The Supreme Court in United Savings Ass'n. v. Timbers of Inwood Forest, 484 U.S. 365 (1988), held that "necessary for an effective reorganization" means that the debtor needs the property for a reorganization that is "**in prospect**." This requires the debtor to show not only that the property is needed, but that the debtor **will be able to successfully reorganize within a reasonable period of time** – generally within one year.

Equity is the excess of the value of the property over all liens against the property.

Adequate protection means that the creditor's interest in the property will not decline in value while the automatic stay is in effect. Only the market value, and not the present discounted value, of the property needs to be protected. As long as the property is insured against loss and not declining in value, the creditor is adequately protected. In addition, a creditor can be adequately protected against any decline in the value of the property by a sufficient equity cushion.

QUESTION 3

Assume the facts in Question 2. What must EasyLoan show to obtain relief from the automatic stay (and what must the Debtor show to avoid relief from stay) so that it can take possession of TRU's inventory, sell it, and use the proceeds of sale to satisfy (part of) the loan? What happens to the portion of the loan that is not paid from any foreclosure sale?

viii. Priority of Distribution

The trustee's job is to sell property of the estate in an orderly manner to maximize the distribution to creditors. The trustee can sell the individual assets in pieces, or can sell the business as a going concern – whatever will realize greater value. The trustee has time to market and sell to get the best price.

The proceeds from the sale of the debtor's assets are used to pay creditors. There is a priority scheme in bankruptcy: The **absolute priority rule** provides that senior creditors must be paid **in full** before junior creditors or interest holders can receive **any** distribution.

Secured creditors in the order of priority under state law will receive payment of their secured claims first from the sale of their collateral.

With respect to distributions to unsecured creditors, there is a list of priority claims in the Bankruptcy Code. The most important priority claims are **administrative claims**, certain **tax claims, claims of employees for unpaid wages,** and **family support claims**.

Administrative claims are claims for providing **post-petition** goods or services to the bankruptcy estate.

Income taxes owing for the 3-4 tax years before bankruptcy are entitled to priority, as are any claims for unpaid withholding taxes.

The bankruptcy code also recognizes and validates **subordination agreements** between creditors.

QUESTION 4

Assume the facts in Problem 2. In addition to the inventory, TRU also owns equipment having a book value of $4 million, and a factory building having a book value of $2 million. TRU owes unsecured trade creditors $800,000, senior debenture holders $1.2 million, and subordinated debenture holders $6 million. Stockholders have invested $3 million in the business. You believe the equipment would only bring $1 million in a liquidation sale, and the land could be sold for $2.5 million at best.

However, you believe that the business as a whole could be sold for $5 million as a going concern (building, inventory, equipment, employees, etc). TRU is completely out of cash and is unable to make the payments that are due to trade creditors and debenture holders.

You have been hired by a large subordinated debenture holder to provide a strategy for maximizing his recovery. Your client wants to know whether he should try to force TRU into bankruptcy, and what his likely recovery would be in and out of bankruptcy. What do you tell your client?

QUESTION 5

Assume the facts in Question 4, except that 80 days ago, TRU was unable to make a required interest payment to the holders of the subordinated debentures. To avoid a default to the subordinated debenture holders (which would have triggered cross defaults on TRU's other loans), TRU proposed an exchange offer under which (1) the amount of the subordinated debentures would be reduced by 30%, (2) the 70% balance of the subordinated debentures would be converted to bonds that would be secured by a first priority security interest in TRU's equipment and building, and (3) any bondholders electing to convert would give exit consents allowing TRU to modify eliminate the covenants in all of the outstanding bonds, including the negative pledge.

All of the subordinated debenture holders accepted the offer and now hold secured bonds of 70% of the amount they held before. TRU is once again out of cash, and cannot make its payments to trade creditors. The trade creditors come to you for advice.

First, calculate the effect of the subordinated debenture holder's prior exchange on the distributions to trade creditors both outside of bankruptcy (liquidation value) and insider of bankruptcy (going concern value) using what you know so far.

Is there something the other creditors can do about the exchange offer? Read on regarding some additional bankruptcy law concepts.

ix. Enhancing the Estate

There are three provisions in the Bankruptcy Code that allow the trustee to set aside and recover pre-bankruptcy transfers of property.

1. The Strong Arm Power (11 U.S.C. § 544(a))

The trustee is given the power of a hypothetical judgment lien creditor or bona fide purchaser of real property on the date of bankruptcy. If the trustee's hypothetical judgement lien or purchase of real property would have **priority** over an actual creditor's lien or interest in property, then the trustee can avoid the transfer and recover the property or invalidate the lien.

The Bankruptcy Code does not tell us what transfers can be avoided by a judgment lien creditor or bona fide purchaser of real property –the Code leaves it to state law to define when a lien creditor would prevail over the transferee. In general, state law gives a lien creditor or bona fide purchaser priority over an **UNPERFECTED** transfer or lien.

2. The Fraudulent Conveyance Power

There are two kinds of fraudulent conveyances: (1) transfers made with "**actual intent**" to hinder, delay or defraud creditors, and (2) transfers made by an **insolvent** debtor without receiving "**reasonably equivalent value**" ("REV") in return for the transfer. Actual intent is very difficult to prove, so most fraudulent conveyance cases involve insolvency and lack of REV.

Both state law and the Bankruptcy Code define "value" for purposes of determining REV as follows: **"'value' means property, or satisfaction or securing of a present or antecedent debt of the debtor, but does not include an unperformed promise to furnish support to the debtor or to a relative of the debtor."** 11 U.S.C. 548(d)(2).

Every state has adopted a law allowing creditors outside of bankruptcy to avoid fraudulent conveyances. The state statutes allow creditors to sue the recipient of a fraudulent transfer for four to six years after the transfer is made in order to recover their claim, and sometimes longer periods of the transfer was not known to the creditor.

The Bankruptcy Code allows the trustee to avoid fraudulent transfers within two years before bankruptcy. A trustee in bankruptcy is given the power to avoid fraudulent conveyances under state law if an actual creditor exists who could avoid the transfer.

3. The Preference Power

A preference occurs when the debtor transfers property to a creditor on account of an antecedent debt, within 90 days before bankruptcy (or one year if the transfer is to an insider), in preference to other creditors who did not receive the property. The debtor must have been insolvent when the transfer was made, and the creditor must get more value from the transfer than the creditor would get in a Chapter 7 bankruptcy distribution.

Preference exceptions. There are many preference exceptions. The most important exceptions are:

1. The **Ordinary Course** of Business exceptions. The debt must have been incurred in the ordinary course of business of both the debtor and the creditor, and the payment must have been made in the same manner as previous payments, or according to ordinary business terms.

2. The **New Value** Exception. If the creditor gives the debtor new value after receiving a preferential transfer, the new value given reduces the amount of the preferential transfer. The new value must be given AFTER the preferential transfer.

3. **De Minimis** Exception. Consumer preference of less than $600, or business preference of less than $5,475.

4. **Security Interest Perfection**. If a security interest is perfected within 30 days after it is made, the "transfer" for preference purposes will be deemed to occur when the security interest was made (and thus the perfection will not be preferential). If it is not perfected within 30 days, then the transfer will occur upon perfection (and if that occurs within 90 days of bankruptcy the security interest can be avoided).

QUESTION 6

Lender made an unsecured loan to borrower 2 years ago. Upon learning that borrower was having financial problems, lender demanded that borrower sign a mortgage on borrower's house to secure repayment of the loan. The mortgage was recorded the day before bankruptcy. Can the lien be avoided by the trustee under the strong arm power? The fraudulent conveyance power? The preference power?

What if the mortgage was not yet recorded when the bankruptcy was filed?

QUESTION 7

The debtor has lost his job, and has no way to repay his $50,000 in credit card debts. Before filing bankruptcy, the debtor donates his last $10,000 to the Salvation Army rather than see it go to pay his creditors. Is the transfer avoidable under the strong arm, fraudulent conveyance or preference powers?

QUESTION 8

Can the trade creditors challenge the exchange offer in Question 5 in bankruptcy under the strong arm power, the fraudulent conveyance power, or the preference power? What would you recommend that the trade creditors do (and by when) to protect their interests?

x. The Discharge

Individual debtors obtain a discharge of their debts in bankruptcy.

The discharge means that the debtor is no longer personally obligated to pay the discharged debts. The creditors are ordered by the Bankruptcy Code not to attempt to collect discharged debts, and can be held in contempt of court if making any attempt.

Corporations and other entities do not receive a discharge under Chapter 7. Entities do not need a discharge since the entity is liquidated and, in essence dies in Chapter 7. After Chapter 7, the entity is a shell, owning no assets but owing debts that can never be collected. Individuals need a discharge because they continue to have financial lives after Chapter 7. The individual debtor’s future earnings are free from the claims of discharged creditors.

Certain debts are not dischargeable in bankruptcy. Some debts, like student loans, are automatically non-dischargeable. Other debts are excepted from discharge only if the creditor timely seeks a non-dischargeability determination from the bankruptcy court for one of the listed grounds (like fraud, breach of fiduciary duty, and willful or malicious injury to another person or their property). Debts that are not discharged continue to be owed after bankruptcy.

The discharge only eliminates the debtor’s **personal liability** for the debt. The discharge does <u>not</u> eliminate any other person’s liability for the debt, and it does not eliminate **liens** on property.

Tuesday - Class 2

C. Chapter 11 – Business Reorganization

Chapter 11 is the main business reorganization chapter of the Bankruptcy Code. Instead of liquidating the debtor's assets and closing down the business, Chapter 11 seeks to preserve the business as a going concern.

a. Availability

Chapter 11 is available to both individuals and businesses. However, because Chapter 11 is a very expensive process, only wealthy individuals consider filing under Chapter 11.[1]

b. New Parties

xi. The Debtor-in-Possession

The main player in Chapter 11 cases is the Debtor in Possession or DIP. The DIP consists of the same people who operated the debtor before bankruptcy, but they are now clothed with all of the powers of an independent trustee, and are treated as if they were different from the prepetition debtor. A trustee is only appointed in Chapter 11 cases on the request of a party in interest, and a showing of "cause." Absent fraud or gross mismanagement, the DIP runs the case by controlling property of the estate, and the plan process during the "exclusivity period" (see below).

> ***11 U.S.C. § 1107. Rights, powers and duties of debtor in possession.*** *Subject to any limitations on a trustee serving in a case under this chapter, and to such limitations or conditions as the court prescribes,* ***a debtor in possession shall have all the rights****, other than the right to compensation under section 330 of this title,* ***and powers, and shall perform all the functions and duties****, except the duties specified in sections 1106 (a)(2), (3), and (4) of this title,* ***of a trustee serving in a case under this chapter****.*

1. Committees

[1] The Bankruptcy Code was amended in 2005 to make it even less attractive for individuals by incorporating the less attractive features of Chapter 13 (for example, no discharge until all plan payments are completed, and all of the debtor's projected disposable income" must be used to make payments during the 5 year term of the plan). Only individuals who have too much debt for Chapter 13, or have very large business interests and need the flexibility of Chapter 11, are likely to consider Chapter 11.

Every Chapter 11 case is supposed to have an **official committee** of unsecured creditors, ordinarily consisting of the creditors who hold the **7 largest claims**. The United States Trustee, a governmental official, appoints the unsecured creditors' committee, and can adjust its membership to assure fair representation of unsecured creditors.

The Court can appoint additional official committees to represent other constituent groups, such as stockholders or bondholders, but is often reluctant to do so because the bankruptcy estate must pay the professional expenses incurred by each committee.

Unofficial committees are also liberally allowed. Professionals working for unofficial committees must arrange for payment from their members, and can only recover expenses from the estate if they can establish that they made a substantial contribution to the case.

xii. The Chapter 11 Plan Process

1. The Disclosure Statement and Solicitation of Votes

The Bankruptcy Code implies that the first step in the Chapter 11 reorganization process is to develop a plan of reorganization in a vacuum, prepare a detailed disclosure statement that will give all creditors the information they need to vote on the plan, submit the disclosure statement to the bankruptcy court for approval, obtain approval, solicit votes, and hold a confirmation hearing. The problem is that this procedure puts the cart before the horse. Before a plan and disclosure statement can be developed, the debtor must negotiate with creditors to determine terms that will be acceptable to the requisite majorities of creditors to obtain the needed votes for confirmation. Yet the Bankruptcy Code strictly prohibits the debtor from soliciting votes before giving the creditor a bankruptcy court approved disclosure statement.

The anti-solicitation problem is dealt with in practice by not seeking formal voting commitments from creditors during the negotiation process. Instead, the debtor asks whether the structure would likely (no commitment) be acceptable to the creditor. If enough creditors stay yes, then the disclosure statement is prepared, approval from the bankruptcy court sought, voting solicited and hopefully the creditors vote as they suggested they would.

The disclosure statement is the key document. It must contain "adequate information" which is defined as information of a kind and in sufficient detail to enable a typical creditor of the class solicited to make an informed judgment about this plan. This is very much like the securities law requirement of providing material information to offerees, and the disclosure statement is very much like a prospectus soliciting an investment. Unlike a prospectus, however, the disclosure statement must be approved by the bankruptcy court before it is submitted to creditors, while a prospectus is subject to later challenge on the basis of hindsight. The advance court approval process provides protection for the debtor from later challenges to the adequacy of disclosure (absent serious intentional fraud on the court, of course).

On the other hand, the disclosure statement process is slow. The debtor (or other plan proponent) must submit the statement to the court. A month later, the court will hold a hearing on the adequacy of disclosure and consider objections and require revisions. The revision process may go on for a long time, with multiple hearings. Once the disclosure statement is finally approved, the solicitation process begins – another month before the votes are returned and tabulated. And then the process reaches its denouement – the confirmation hearing. It is at confirmation that the bankruptcy court decides whether the plan of reorganization lives or dies. Often if the plan is not confirmed the court will convert to Chapter 7 for liquidation and death of a business. But the Court can also let the plan proponent try again with a new plan.

2. Pre-Packs

An alternative to the post-bankruptcy process of solicitation and voting is known as the **pre-packaged plan** or a "pre-pack." With a pre-pack, the disclosure, solicitation and voting takes place before the bankruptcy petition is filed, and without bankruptcy court involvement. The debtor then files a bankruptcy petition, the plan, enough votes to confirm the plan, and the unapproved disclosure statement that was used to solicit votes and seeks immediate confirmation.

The bankruptcy court must find that the disclosure made to the voting creditors before bankruptcy would have met the Bankruptcy Code's requirements for disclosure. The pre-pack process can save considerable time – if all goes well, the debtor can be in and out of bankruptcy in a matter of weeks. But if the court decides that the disclosure statement used was not adequate, the plan dies and the debtor must start over from scratch. It is a risky move, but of course the bankruptcy courts tend to be less picky about disclosure problems because the result of a disclosure insufficiency will be to cancel the entire prepetition solicitation.

3. Exclusivity

If no trustee has been appointed, the debtor-in-possession has the exclusive right to file a plan during the first 120 days of the bankruptcy case, and this exclusive period can be extended by the bankruptcy court for up to 18 months. Once the debtor files a plan during the exclusivity period, the debtor is given until two months after the end of the exclusivity period to confirm the plan before competing plans may be filed. This gives the debtor significant leverage with the creditors in the plan negotiations.

4. Classification

Creditor claims must be placed in classes, and the plan must set forth the treatment of claims in each class. The Bankruptcy Code requires that claims in a class be substantially similar. Dissimilar claims may not be placed in the same class. This requires most secured claims to be separately classified from unsecured creditors, and from other secured creditors who have liens on different collateral (or liens of different priority on the same collateral). As a general rule, secured creditors are placed in separate classes unless they share a joint lien (such as secured bondholders).

The Bankruptcy Code does not prohibit classifying similar claims in separate classes. Because separating similar claims into different classes can constitute vote manipulation, the Courts have ruled that similar claims may be separately classified only in two circumstances: (1) the creditors have different financial interests in the reorganized company, and therefore may have a different voting motive, and (2) the debtor has a "good business reason" for separately classifying the similar claims other than gerrymandering votes.

5. Voting

Once the disclosure statement is approved by the bankruptcy court as containing "adequate information," the plan, disclosure statement, and a ballot are sent to each creditor and equity security holder, along with an order setting the deadline for voting.

Voting is by class. A class of creditors accepts the plan if **at least 2/3 in amount** of claims AND **more than ½ in number** of creditors in the class vote in favor of the plan. A class of equity security holders accept if at least 2/3 in amount of equity security holders vote in favor of the plan. **Only**

voters count. Creditors who do not vote are ignored in both the numerator and denominator.

QUESTION 9

Which of the following classes have accepted and which have rejected the plan?

	Class 1	Class 2	Class 3	Class 4	Class 5
Number					
Yes	6	90	51	1	0
No	6	30	50	0	1
Abstain	6	60	90	0	0
Amount					
Yes	$ 500,000	$ 490,000	$ 720,000	$ 50,000	$ -
No	$ 250,000	$ 250,000	$ 250,000	$ -	$ 25
Abstain	$ 500,000	$ 500,000	$ 100,000	$ -	$ -

6. Impairment

If a class is not "impaired," their votes do not matter – they are **deemed** to accept the plan. 11 U.S.C. § 1126(f). Similarly, if a class receives no distribution under the plan, then they are **deemed** to vote against the plan. 11 U.S.C. § 1126(g). Impairment is therefore an important concept.

A class is "impaired" if the creditors' **legal, equitable and contractual rights** have been changed in any way by the plan, **other than** providing for a **cure** of the debtor's default **and reinstatement** of the original terms of the obligation. See 11 U.S.C. §1124. Since any change in rights constitutes impairment, it is very easy for the plan proponent to make some very minor change that the creditors do not care about in order to permit the class's vote to count. Some courts have ruled that "artificial impairment" should not count as true impairment, notwithstanding the language of the statute.

7. Confirmation Requirements

In order for the plan to be confirmed by the bankruptcy court, and become effective, the proponent of the plan must show that all of the requirements in the Bankruptcy Code for confirmation have been met. The proponent of the plan must show good faith and make certain other disclosures, must pay administrative claims in cash on the effective date of the plan, and meet various other minor requirements. The following are the main requirements that must be met in every case:

a. The Best Interests of Creditors Test: 11 U.S.C. § 1129(a)(7)

11 U.S.C. § 1129(a) The Court shall confirm a plan only if all of the following requirements are met: (7) With respect to each impaired class of claims or interests—

> *(A)* ***each holder*** *of a claim or interest of such class—*
>
> *(i) has accepted the plan; or*
>
> *(ii) will receive or retain under the plan on account of such claim or interest property of a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive or retain if the debtor were liquidated under chapter 7 of this title on such date;*

b. One Impaired Accepting Class. 11 U.S.C. § 1129(a)(10)

11 U.S.C. § 1129(a) The Court shall confirm a plan only if all of the following requirements are met:

> *(10) If a class of claims is impaired under the plan, at least one class of claims that is impaired under the plan has accepted the plan, determined without including any acceptance of the plan by any insider.*

c. Feasibility. 11 U.S.C. §1129(a)(11)

11 U.S.C. § 1129(a) The Court shall confirm a plan only if all of the following requirements are met

> *(11) Confirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor to the debtor under the plan, unless such liquidation or reorganization is proposed in the plan.*

d. Acceptance by All Classes. 11 U.S.C. § 1129(a)(8)

In addition to these basic requirements that must be met in EVERY case, the proponent of the plan must show **either** (1) that **all** impaired classes have accepted the plan, or (2) that the plan meets the requirements of the **cramdown** with respecting to the non-accepting classes. 11 U.S.C. §1129(a)(8) and (b).

e. **Exception - The Cramdown** – 11 U.S.C. § 1129(b)

If one or more impaired classes does not accept the plan, the plan can only be confirmed if the requirements of the cramdown are met with respect to the non-consenting class. The cramdown has separate rules for secured creditor classes, unsecured creditor classes, and equity security holder classes. The proponent must show that the plan is both "fair and equitable" and "does not discriminate unfairly." The "fair and equitable" requirement includes detailed rules that must be met.

i. The Secured Creditor Cramdown

11 U.S.C. §1129(b)(2)(A). With respect to a class of secured claims, the plan provides that the holders retain their liens, and

> *(II) that each holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property,*
>
> [alternatively, the debtor can propose to sell the property, or provide secured creditors with the "indubitable equivalent" of their claims.]

What is the distinction between **total value** equal to the allowed amount of the claim and "value as of the effective date of the plan of at least the value of such holder's interest in the estate's interest in such property?"

The Supreme Court defined "value as of the effective date of the plan" to be present discounted value using a discount rate of prime plus 1-3%. Till v SCS Credit, 541 U.S. 465 (2004).

Given that **under**secured claims are split under Section 506(a), how is it possible for the value of the secured claim to differ from the value of the creditor's interest in the collateral? The answer comes from a very complex provision known as the 1111(b)(2) election.

Section 1111 does two things to secured claims. First, Section 1111(b)(1) converts a secured creditor's non-recourse deficiency claim (which would be disallowed under state law) into a recourse claim that will be allowed in bankruptcy. Second, Section 1111(b)(2) allows the secured creditor to make an election to be treated as a fully secured creditor.

11 U.S.C. § 1111(b)(2). *If such an election is made, then notwithstanding section [506](#) [(a)](#) of this title, such claim is a secured claim to the extent that such claim is allowed.*

Using our earlier example, assume that a lender has a claim of $1 million secured by property worth $600,000. If this were a non-recourse loan, the lender would foreclose, receive $600,000 at the sale, and have to write off a $400,000 loss. If this were a recourse loan, the lender would recover $600,000 at the foreclosure sale and could pursue a $400,000 deficiency judgment against the debtor and seek to recover from the debtor's other assets. Under Section 506(a), the creditor has a $600,000 secured claim, and a $400,000 unsecured claim. The unsecured claim would be disallowed in Chapter 7 if non-recourse, or allowed in Chapter 7 if recourse.

In Chapter 11, the deficiency claim will be allowed under Section 1111(b) unless the debtor makes the 1111(b)(2) election. If the election is made, the creditor will give up the $400,000 deficiency claim, but will have a $1 million "secured claim" even though the value of the collateral is only $600,000. What does it mean under the cramdown rules to have a $1 million "allowed secured claim" that is secured by only $600,000 of collateral value?

QUESTION 10

If the debtor makes the 1111(b)(2) election, the statute requires the Debtor to make <u>total payments</u> exceeding the amount of the creditor's secured <u>claim</u>, but the <u>present value</u> of those payments (discounted under the "prime plus" formula from *Till*) must only equal the <u>value of the creditor's interest in the property.</u>

Attempt to apply this cramdown test to the following hypothetical. You will need a spreadsheet and the ability to both amortize a mortgage (using the PMT function in Excel) and calculate the present value of an annuity (using the PV function in Excel) to answer the question.

Debtor owes BigBank a total of $12 million. The loan is secured by a first priority mortgage on the Debtor's 10-story office building. The Court has determined that the current fair market value of the office building is $9 million. The prime rate is currently 7%, and the Court will require the payment of a three hundred basis point premium to compensate BigBank for the risk of being forced to continue its loan to the debtor (discount rate will be 10%). Because the Court will not permit the plan term to exceed 20 years, calculate a monthly payment to be made over a 20 year term that will allow the Debtor to confirm the

plan over BigBank's objection if it makes the 1111(b)(2) election, and will also minimize the debtor's interest expense. Note that the courts have interpreted the Bankruptcy Code to require equal monthly payments over the term.

After you have calculated a monthly payment, consider whether the Debtor could make a lower monthly payment for the same term if BigBank did not make the 1111(b)(2) election. Can you explain why the debtor could not make a lower payment? If the debtor proposes to make the monthly payments to BigBank that you have calculated for the 20 year term, would you recommend that BigBank make the 1111(b)(2) election? When would it be advisable for the creditor make the 1111(b)(2) election?

ii. The Unsecured Creditor Cramdown

With respect to unsecured claims, fair and equitable requires as follows:

> *11 U.S.C. § 1129(b)(2)(B) With respect to a class of unsecured claims—*
>
> > *(i) the plan provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or*
> >
> > *(ii) the holder of any claim or interest that is junior to the claims of such class will* ***not receive or retain*** *under the plan* ***on account of such junior claim or interest any property*** *. . .*

This incorporates the **absolute priority rule** – senior classes must be paid in full with interest before junior classes can receive any distribution on their claims. Since most individual debtors wish to keep ownership of their assets, and the owners of most corporate and partnership entities wish to keep their equity interests (stock or partnership interests, respectfully), debtors have searched for a way to pay maintain ownership without paying unsecured creditors in full. The attempts have become known as the "new value exception." The cases focus on whether the existing equity holders are receiving or retaining any "property on account of their" equity interests, or are instead keeping their equity interest on account of new value that they pay to the bankruptcy estate.

In Norwest Bank Worthington v. Ahlers, 485 U. S. 197 (1988), the Supreme Court rejected a farmer's attempt to provide "new value" by promising render his future labor to the farming operation in return for retaining his ownership of his property, even though unsecured creditors were not being paid in full. The Supreme Court ruled that if there is a new value exception, it would require the payment of "money or money's worth," and a promise of future labor – so-called sweat equity" would not qualify as new value.

The Supreme Court's most recent ruling on the new value exception is In re 203 North LaSalle Partnership, 526 U.S. 434 (1999). In that case, the partnership proposed a plan that would not pay objecting classes of creditors in full, but would allow the partners to purchase their partnership interests for cash. The partnership argued that they did not receive their partnership interest on account of their old partnership interests, but rather on account of their new payment. The court held that the partnership's exclusive right to propose a plan and exclusive right under the plan to buy the equity constituted an interest in property that they received on account of their old partnership interests, and therefore the absolute priority rule was violated. The court suggested that the partners may be able to succeed with a "new value exception" plan if they were the highest bidders for the equity in an open bidding process, or possibly if others were allowed to propose competing plans.

8. The Chapter 11 Discharge

The Chapter 11 discharge is much broader than the Chapter 7 discharge. It discharges all debtors (individual or corporate) from all debts not provided for in the plan. Therefore, the plan of reorganization becomes binding on all creditors after confirmation, and any obligations not paid pursuant to the plan are discharged.

xiii. Section 363 Sales

The new rage in bankruptcy reorganizations is a sale of all of the debtor's assets to a new entity formed shortly after the bankruptcy petition is filed. This is the method utilized by General Motors, Chrysler, and many other large businesses within the past few years. Although liquidating plans of reorganization are authorized by the Bankruptcy Code, these sales take place early in the case without complying with the Chapter 11 plan process. Section 363 allows the trustee with Bankruptcy Court approval to use, sell or lease property of the estate outside of the ordinary course of business.

Section 363 sales have been criticized for subverting the disclosure, solicitation and voting requirements of Chapter 11. After the sale of all of the debtor's assets early in the case, what remains of the bankruptcy is a straight forward distribution of the proceeds of sale, either under Chapter 7 or as part of a liquidating plan.

The primary objection to Section 363 sales is the so-called "sub rosa plan." The court of appeals in Chrysler rejected the argument that the sale of all assets to a newly created entity in return for stock and the assumption of certain liabilities constituted a "sub rosa plan." The court said that only a plan which tied the hands of the bankruptcy court in distributing the proceeds of sale would be a "sub rosa plan." Other courts have held that sales of substantially all of the assets of a corporation should not be allowed outside of a plan unless the quick sale is necessary because the assets will deteriorate or because a significantly higher price can be obtained from a quick sale. Some academics have argued that the court should reject sales to new entities that will be owned by the old participants in the corporation (such as General Motors), while allowing sales to new entities owned by new investors (such as Chrysler's sale to an entity controlled by Fiat). The precise scope of the "sub rosa plan" doctrine has yet to be determined.

QUESTION 11

Shortly after filing a Chapter 11 petition, TRU in Question 3 proposes to sell all of its assets to NewCorp, a newly-created corporation, in return for (1) a $3,975,000 million promissory note, and (2) the assumption of EasyLoan's $1,025,000 loan. NewCorp is wholly owned by the existing stockholders of TRU. Assume the price being paid by NewCorp is the highest obtainable. Would a plan to accomplish the same objective be confirmable over the objection of the other unsecured creditors? Should the sale be approved at the beginning of the case without complying with the solicitation and voting processes of Chapter 11?