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**SUMMATIVE (FORMAL) ASSESSMENT: MODULE 3A**

**THE INSOLVENCY SYSTEM OF THE UNITED STATES**

This is the **summative (formal) assessment** for **Module 3A** of this course and is compulsory for all candidates who **selected this module as one of their compulsory modules from Module 3**. Please read instruction 6.1 on the next page very carefully.

If you selected this module as **one of your elective modules**, please read instruction 6.2 on the next page very carefully.

**The mark awarded for this assessment will determine your final mark for Module 3A**. In order to pass this module, you need to obtain a mark of 50% or more for this assessment.

**INSTRUCTIONS FOR COMPLETION AND SUBMISSION OF ASSESSMENT**

**Please read the following instructions very carefully before submitting / uploading your assessment on the Foundation Certificate web pages.**

1. You must use this document for the answering of the assessment for this module. The answers to each question must be completed using this document with the answers populated under each question.

2. All assessments must be submitted electronically in MS Word format, using a standard A4 size page and a 11-point Arial font. This document has been set up with these parameters – **please do not change the document settings in any way**. **DO NOT** submit your assessment in PDF format as it will be returned to you unmarked.

3. No limit has been set for the length of your answers to the questions. However, please be guided by the mark allocation for each question. More often than not, one fact / statement will earn one mark (unless it is obvious from the question that this is not the case).

4. You must save this document using the following format: **[student number.assessment3A]**. An example would be something along the following lines: 202021IFU-314.assessment3A. **Please also include the filename as a footer to each page of the assessment** (this has been pre-populated for you, merely replace the words “studentnumber” with the student number allocated to you). Do not include your name or any other identifying words in your file name. **Assessments that do not comply with this instruction will be returned to candidates unmarked**.

5. Before you will be allowed to upload / submit your assessment via the portal on the Foundation Certificate web pages, you will be required to confirm / certify that you are the person who completed the assessment and that the work submitted is your own, original work. Please see the part of the Course Handbook that deals with plagiarism and dishonesty in the submission of assessments. **Please note that copying and pasting from the Guidance Text into your answer is prohibited and constitutes plagiarism. You must write the answers to the questions in your own words**.

6.1If you selected Module 3A as one of your **compulsory modules** (see the e-mail that was sent to you when your place on the course was confirmed), the final time and date for the submission of this assessment is **23:00 (11 pm) GMT on 1 March 2021**. The assessment submission portal will close at 23:00 (11 pm) GMT on 1 March 2021. No submissions can be made after the portal has closed and no further uploading of documents will be allowed, no matter the circumstances.

6.2 If you selected Module 3A as one of your **elective modules** (see the e-mail that was sent to you when your place on the course was confirmed), you have a **choice** as to when you may submit this assessment. You may either submit the assessment by **23:00 (11 pm) GMT on 1 March 2021** or by **23:00 (11 pm) BST on 31 July 2021**. If you elect to submit by 1 March 2021, you **may not** submit the assessment again by 31 July 2021 (for example, in order to achieve a higher mark).

7. Prior to being populated with your answers, this assessment consists of **8 pages**.

**ANSWER ALL THE QUESTIONS**

**QUESTION 1 (multiple-choice questions) [10 marks in total]**

Questions 1.1. – 1.10. are multiple-choice questions designed to assess your ability to think critically about the subject. Please read each question carefully before reading the answer options. Be aware that some questions may seem to have more than one right answer, but you are to look for the one that makes the most sense and is the most correct. When you have a clear idea of the question, find your answer and mark your selection on the answer sheet by highlighting the relevant paragraph **in yellow**. Select only **ONE** answer. Candidates who select more than one answer will receive no mark for that specific question.

**Question 1.1**

FabCo, based in Utah, owes SupplyCo, based in Mexico, US$10,000 on a past-due invoice. May SupplyCo file an involuntary petition to place FabCo into chapter 11 bankruptcy proceedings?

1. Yes.
2. Yes, if FabCo has fewer than 12 non-contingent, non-insider creditors.
3. Yes, if other creditors owed at least US$5,775 join in the petition.
4. No, because SupplyCo doesn’t know whether FabCo is insolvent.
5. No, because SupplyCo is not a US company.

**Question 1.2**

Which of the following is a *mandatory*, rather than *discretionary*, basis to deny recognition of a foreign judgment under state law based on one of the Uniform Acts?

1. The foreign judgment is subject to appeal in the foreign country.
2. The foreign judgment is an injunction.
3. The foreign judgment was issued by a court, contrary to the parties’ agreement to arbitrate.
4. The defendant did not have sufficient notice of the foreign proceeding to put on a defense.
5. The foreign judgment is inconsistent with another final judgment on the same subject matter.

**Question 1.3**

Which of the following is likely to be a party in interest in the bankruptcy of XYZ Corp?

1. A shareholder in ABC Corp, to which XYZ Corp is substantially indebted.
2. A journalist writing about XYZ Corp’s bankruptcy.
3. A shareholder in MNO Corp, which owns all of XYZ Corp’s shares.
4. A retired employee of XYZ Corp who receives payments from the company’s pension plan.
5. A non-profit organization that advocates for companies like XYZ Corp to be held responsible for climate change.

**Question 1.4**

If a debtor rejects an executory trademark license agreement under which it licenses a trademark to its counterparty, which of the following is true:

1. The counterparty must immediately stop using the trademark.
2. The counterparty can continue using the trademark for the remaining period of the license.
3. The counterparty has a claim for damages for breach of contract.
4. Both (a) and (c).
5. Both (b) and (c).

**Question 1.5**

In which of the following circumstances may a counterparty enforce a contractual *ipso facto* clause?

1. The contract would obligate the counterparty to extend a loan to the debtor.
2. The contract is a lease of real property.
3. The clause is triggered by the bankruptcy filing of a third party, not the debtor.
4. Both (a) and (c).
5. *Ipso facto* clauses are never enforceable against a debtor.

**Question 1.6**

What does a chapter 11 debtor have exclusivity to propose for the first 120 days of proceedings?

1. Avoidance actions.
2. A plan of reorganization.
3. DIP financing.
4. Lifting the automatic stay.
5. Formation of an equity committee.

**Question 1.7**

Which of the following is **not** a requirement to confirm a “cramdown” plan?

1. Acceptance of the plan by all classes of secured creditors.
2. Acceptance of the plan by at least one class of impaired, non-insider creditors.
3. The plan is fair and equitable to dissenting classes of creditors.
4. The plan does not discriminate unfairly against dissenting classes of creditors.
5. The dissenting creditors receive no less than they would under a liquidation scenario.

**Question 1.8**

When may distributions to creditors diverge from the absolute priority rule?

1. In a chapter 7 proceeding with consent of the affected senior creditor.
2. In a chapter 7 proceeding with consent of the affected junior creditor.
3. In a chapter 11 proceeding with consent of the affected senior creditor.
4. In a chapter 11 proceeding with consent of the affected junior creditor.
5. The absolute priority rule cannot be deviated from.

**Question 1.9**

Who may serve as a foreign representative to seek recognition of a foreign proceeding under chapter 15?

1. An officer of the debtor if it is a debtor-in-possession in the foreign proceeding.
2. The board of directors of the debtor if it is a debtor-in-possession in the foreign proceeding.
3. An insolvency professional appointed by the court overseeing the foreign proceeding.
4. An insolvency professional appointed by a creditor where the foreign proceeding is an involuntary receivership.
5. All of the above.

**Question 1.10**

Which of the following is *not* available as relief in a chapter 15 proceeding?

1. Sale of US property free and clear pursuant to section 363.
2. Prosecution of avoidance actions pursuant to section 544 .
3. Entrusting the management of US assets to the foreign representative.
4. Application of the automatic stay under section 362 to the debtor’s interests in US property.
5. Discovery about the debtor’s assets.

**QUESTION 2 (direct questions) [10 marks]**

**Question 2.1 [maximum 1 mark]**

**What two alternative qualifications render a corporation eligible to be a debtor in a US chapter 7 or 11 proceeding?**

The two alternative qualifications necessary in order to be eligible for US chapter 7 or 11 proceedings are:

1. the presence of the debtor or its place of business being in the US, or
2. any of the debtor's assets being in the US (which can also include very minimal or even intangible assets such as a claim under US law).

**Question 2.2 [maximum 2 marks]**

**What is an executory contract?**

Executory contracts are not defined by any particular law but are a creature of case law. Simply put, an executory contract is a contract where there are material unperformed obligations by both the creditor and debtor parties. For example, if a debtor to a contract is service provider and as at the date of any petition under the Bankruptcy Code the services have only been partially provided and payment has not been made then the underlying contract between the parties will be said to be executory. This being the case, the debtor could elect to (i) reject the contract, (ii) assume the contract, or (iii) assume and assign the contract.

A chapter 7 trustee has 60 days from the date of the chapter 7 petition to make a decision as to assume, assign, or reject the executory contract. In chapter 11 cases the debtor has until the confirmation of its reorganisation plan to make this decision, save for unexpired non-residential leases which must be decided upon within 120 days of the order for relief.

**Question 2.3 [maximum 2 marks]**

**What is a “priming lien” and what requirements must be met for such a lien to be granted to secure DIP financing?**

If a debtor in possession is unable to obtain increased unsecured debt funding then, pursuant to section 364(d) of the Bankruptcy Code, it can also offer a priming lien, which is a new lien on assets which rank senior to existing pre-petition liens on the same assets/collateral. The debt secured by the priming lien will be paid prior to payments of other debts secured by the same assets/collateral, irrespective of the fact of whether the source of the payment is the sale of the common assets/collateral. A priming lien is only available to a debtor where it can prove to the court that it cannot otherwise obtain financing. Moreover, if the debtor wishes to prime assets with existing liens then it needs to obtain consent from the lenders being primed, or, rather, it needs to show to the court that the interests of the lenders being primed in the asset/collateral are being adequately protected against any kind of diminution of value from the application of a new priming lien. Section 361 of the Bankruptcy Code defines what "adequate protection" requirements must be demonstrated, which may includes: *"(1)requiring the trustee to make a cash payment or periodic cash payments to such entity, to the extent that the stay under section 362 of this title, use, sale, or lease under section 363 of this title, or any grant of a lien under section 364 of this title results in a decrease in the value of such entity’s interest in such property; (2)providing to such entity an additional or replacement lien to the extent that such stay, use, sale, lease, or grant results in a decrease in the value of such entity’s interest in such property; or (3)granting such other relief, other than entitling such entity to compensation allowable under section 503(b)(1) of this title as an administrative expense, as will result in the realization by such entity of the indubitable equivalent of such entity’s interest in such property."*

**Question 2.4 [maximum 2 marks]**

**In voting on a plan of reorganization, which class(es) of creditors are (i) deemed to accept the plan, (ii) deemed to reject the plan and (iii) permitted to vote on the plan? What vote is necessary for a class of creditors to accept a plan?**

Classes of creditors are said to be either "unimpaired" or "impaired" in a chapter 11 reorganisation. A class is "impaired" unless the reorganisation plan leaves those members of the class' claims unaltered. It is only "impaired" classes that have the right to vote on the plan; "unimpaired" classes do not have the right to vote.

A class of creditors approves the reorganisation plan if a simple majority of the creditors in the class holding at least two-third of value of claims in the class vote in favour. However, for shareholders' interests the threshold requirement is if two-thirds in amount of interests vote in favour.

Unimpaired classes do not have the right to vote and are deemed to accept the plan, whereas a class that will receive nothing under the reorganisation plan will be deemed to reject the plan.

**Question 2.5 [maximum 3 marks]**

**How does the automatic stay available in chapter 15 proceedings differ from that available in chapter 11 proceedings?**

The key differences between a chapter 15 stay versus a chapter 11 stay are:

* Breadth - a chapter 15 stay only applies to the debtor's property within the jurisdiction of the United States whereas a chapter 11 stay has extraterritorial effect on the debtor's assets wherever they are located.
* Carve-outs - a chapter 11 stay has only a few limited number of carve outs (e.g. criminal proceedings and family matters), whereas the chapter 15 stay has a rather large carve out in that s.1520(c) of Title 11 of Chapter 15 provides that the stay does not apply to the filing of a plenary US bankruptcy proceedings.
* Discretion - where a chapter 15 action recognises a foreign-non main proceeding then the stay relief (which is automatic in respect of the recognition of foreign main proceedings) is only granted on a discretionary basis; whereas in chapter 11 relief all the stays are automatic and can be extended to third parties on a discretionary basis.

**QUESTION 3 (essay-type questions) [15 marks in total]**

**Question 3.1** **[maximum 3 marks**]

**What fiduciary duties do directors of Delaware corporations owe and to whom are the duties owed in the ordinary course of business? To whom are duties owed when the corporation is potentially or actually insolvent?**

In the ordinary course of business directors of Delaware corporations owe a fiduciary duty of loyalty to their corporations best interest and a duty of care to make educated decisions. Directors have the protections of the "business judgment rule" which provides that they are protected from liability for errors of judgment and where they are presumed to act in good faith and on the basis of reasonable information which can only be rebutted by a demonstration that a majority of the board of directors were not informed reasonably, did not honestly believe that their decisions were in the best interests of the corporation, and/or were not acting in good faith. If a corporation's certificate of incorporation excludes a director's liability for breach of duty of care then a director will not be held to that duty.

The duties noted above are owed to the corporation and its shareholders even where the corporation itself is potentially insolvent. Indeed, in 2007 the Delaware courts in the case of *North Am Catholic Educational Programming Foundation, Inc v Gheewalla,* 930 A.2d 92, 103 (Del 2007) clarified that even where a company is operating "in the zone of insolvency" or is factually insolvency the directors still do not owe duties to the creditors given the conclusion by Chief Justice Holland "*that creditors of a Delaware corporation that is either insolvent or in the zone of insolvency have no right, as a matter of law, to assert direct claims for breach of fiduciary duty against the corporation's directors*".

**Question 3.2 [maximum 3 marks]**

**Describe the circumstances in which a bankruptcy court may enter a final order, who reviews appeals from bankruptcy court orders and how non-final orders are reviewed.**

Section 157, of Chapter 6 of Part I of Title 28 of the USC distinguishes between "core" and "non-core" proceedings.

Pursuant to section 157(b)(1) of Title 28 of the USC bankruptcy judges may "*hear and determine all cases under title 11 [i.e. Bankruptcy] and all core proceedings arising under title 11….".* A non-exhaustive list of "core proceedings" is outlined in section 157(b)(2) and includes such matters as:

*"(A) matters concerning the administration of the estate;*

*(B) allowance or disallowance of claims against the estate or exemptions from property of the estate, and estimation of claims or interests for the purposes of confirming a plan under chapter 11, 12, or 13 of title 11 but not the liquidation or estimation of contingent or unliquidated personal injury tort or wrongful death claims against the estate for purposes of distribution in a case under title 11;*

*(C) counterclaims by the estate against persons filing claims against the estate;*

*(D) orders in respect to obtaining credit;*

*(E) orders to turn over property of the estate;*

*(F) proceedings to determine, avoid, or recover preferences;*

*(G) motions to terminate, annul, or modify the automatic stay;*

*(H) proceedings to determine, avoid, or recover fraudulent conveyances;*

*(I) determinations as to the dischargeability of particular debts;*

*(J) objections to discharges;*

*(K) determinations of the validity, extent, or priority of liens;*

*(L) confirmations of plans;*

*(M) orders approving the use or lease of property, including the use of cash collateral;*

*(N) orders approving the sale of property other than property resulting from claims brought by the estate against persons who have not filed claims against the estate;*

*(O) other proceedings affecting the liquidation of the assets of the estate or the adjustment of the debtor-creditor or the equity security holder relationship, except personal injury tort or wrongful death claims; and*

*(P) recognition of foreign proceedings and other matters under chapter 15 of title 11."*

Additionally, in *Executive Benefits Ins Agency v Arkinson,* 134 S. Ct. 2165 (2014) the Supreme Court held that judges in bankruptcy courts may determine a core proceeding over which they lack constitutional authority by way of the issuances of a report to a district court. Additionally, and following the judgment in *Executive Benefits,* the Bankruptcy Rules not require that litigants state in their pleadings whether they consent to the entry of final orders by the bankruptcy court.

Orders of the bankruptcy court can be appealed by the litigants and any other party who was adversely affected by the order. Generally, district courts hear appeals from the bankruptcy courts in the district in which they sit but in some circuit bankruptcy order appeals are referred to a Bankruptcy Appellate Panel which is comprised of judges from the bankruptcy courts. From the district court or the Bankrupt Appellate Panel appeals are heard in the Circuit Court of Appeals. However, in some circumstances appeals from the district court of the Bankrupt Appellate Panel may be heard in the court of appeals where there is a certification that the appeal raises a unique question of law or the immediate appeal will materially advance the proceedings.

In relation to non-final orders, bankruptcy courts do not have the power to issue final orders in relation to "non-core" proceedings (unless consent has been given) but may submit a proposed finding of fact and conclusions of law to a district court for their review and final determination, but before which the parties may make submissions and objections.

**Question 3.3 [maximum 4 marks]**

**Describe how claims for recovery of preferences, fraudulent conveyance and constructive fraudulent conveyance differ.**

Preferences, fraudulent conveyance, and constructive fraudulent conveyance are all concerned with the recovery of a debtor's property (put broadly) that was distributed prior to a petition date, but under different circumstances and across different time periods.

* Timings: A preference transaction's suspect period for transfers to third parties is 90 days prior to the petition date and, for insiders (e.g. the debtor's directors), is one year before the petition date. However, fraudulent conveyance and constructive fraudulent conveyance laws are aimed at transactions over a longer period as these laws apply to transactions within a two year period prior to the petition date.
* Fraud: Fraudulent conveyance relates to showing that a debtor made a transfer or took on a liability "*with actual intent to hinder, delay, or defraud any entity to which the debtor was or became… indebted*" (USC 11 section 548(a)). However, neither preference or constructive fraudulent conveyance (despite its name) requires establishing fraud to satisfy their conditions and in a preference there is no need to show any fault of either the debtor or the recipient of the transaction whatsoever.
* Value: Constructive fraudulent conveyance is established where it can be shown that a debtor received less than reasonably equivalent in value in exchange for the transfer of the property or the taking on of the liability. However, such a test is not relevant to fraudulent conveyance which is primarily focused on the defrauding angle of any transaction and nor is it relevant to preference transactions which considers whether the transaction to the party was more than that party would have received in a chapter 7 liquidation had the transfer not been made.
* Recipient: Where a preference is found a transaction is voided and returned to the estate of the debtor the recipient of the preference has an unsecured claim for the value of the voided transaction in the estate of the debtor. However, with the recipients of actual or constructive fraudulent transfers, they may retrain the property they received (or enforced the obligations created in their favour) if they took them for value and in good faith

**Question 3.4 [maximum 5 marks]**

**How does a US bankruptcy court determine whether a foreign proceeding is a main or non-main proceeding under chapter 15?**

To begin, a chapter 15 petition can only be brought by the foreign representative of the debtor who is subject to foreign insolvency proceedings. Once the petition has been brought then the US court will need to ascertain whether the foreign proceedings to which the foreign representative has been appointed are "main" or "non-main" proceedings.

Foreign main proceedings are those which are commenced in the debtor's centre of main interest. There is a rebuttable presumption that a debtor's centre of main interest is its place of incorporation but other relevant factors include the location of headquarters, management, main assets, creditors, jurisdiction whose law will apply to most of the debtor's disputes. In *Morning Mis Holdings Ltd v Krys (In re Fairfield Sentry Ltd),* 714 F 3d 127 the courts held that a centre of main interest should be ascertainable by creditors or third parties on an objective basis. The centre of main interest is assessed as at the date of the US petition, not the commencement of the foreign proceedings.

Proceedings outside the location of the debtor's centre of main interest can only be classified as "non-main" if the debtor has an "establishment" in that jurisdiction. An "establishment" is said to be a place where the debtor carried on some form of non-transitory commercial/financial activity prior the chapter 15 proceedings.

However, in the *Bear Stearns* 374 BR 122 (Bankr SDNY 2007) the court was faced with a situation where it could not find that liquidation proceedings of a Cayman-incorporated fund were foreign main proceedings as it could not be said that the Fund's centre of main interest was in the Cayman Islands as it was set up on an "exempt" basis and also licenced on the basis that it had no operations within the Cayman Islands. However, the US court could also not find that the Cayman liquidation was a foreign non-main proceeding as the Fund did not have an establishment in the Cayman Islands. Consequentially, a process has been developed by foreign representatives to move the COMI of such a debtor to the required/preferred jurisdiction before making a chapter 15 petition to the US courts. Despite some opprobrium by commentators the US courts have accepted centre of main interest shifting unless such a shift can be found to have been conducted in bad faith.

**QUESTION 4 (fact-based application-type question) [15 marks in total]**

**Question 4.1 [maximum 5 marks]**

**Rental Corporation is a publicly-traded company that leases office space from office building owners and sublets the space to small businesses. It has recently announced that it is being investigated by the US Department of Justice Fraud Division (DOJ) regarding allegedly fraudulent misstatements of revenues; shortly after the announcement, a securities class action litigation was filed against Rental Corporation in New York federal court. Due to the increase in the numbers of businesses operating remotely, Rental Corporation has suffered a decline in revenues. As a result, it has failed to pay rent on some of its office space leases and it has just defaulted on its quarterly payment on its credit facility. What would be the effect of a chapter 11 petition being filed by Rental Corporation on each of (i) the DOJ investigation, (ii) the securities class action litigation; (iii) the delinquent leases and (iv) the credit facility?**

In the scenario where Rental Corporation files a chapter 11 petition it will be said to have commenced this voluntarily. A voluntary petition requires no allegation of insolvency but as a voluntary petitioner Rental Corporation will, alongside its petition, need to also file a schedule which discloses is assets, which includes all property, executory contracts, unexpired leases, its personal property, and identify its secured and 20 largest unsecured claims which will become publically available.

The DOJ investigation

The DOJ investigation is not impacted by the filing of a chapter 11 petition as, whilst an automatic stay does come into effect, both criminal and regulatory investigations are excluded from the stay. As such, the DOJ will be able to continue their investigations and Rental Corporations will need to comply with that.

The securities class action litigation

Upon filing a chapter 11 petition an estate is created over all of Rental Corporation's assets as of the petition date and an automatic stay comes into effect immediately upon filing. The stay covers all litigation and prevents the enforcement of judgments and of security without the leave of the court. As such, given that the stay includes staying the continuation of any existing actions that were commenced prior to filing the securities class action litigation will be stayed and any party that takes action in violation of the stay will be in contempt of court. The plaintiffs in the securities class action may make motions to lift or modify the stay in an attempt to enable them to continue with their litigation. If they do make such a motion then the stay will expire within 30 days unless the court intervenes pending a final hearing.

The delinquent leases

Under section 365 of the Bankruptcy Code a debtor may assume or reject any "unexpired leases", subject to court approval, following the filing of a chapter 11 petition. If Rental Corporation assume the leases they will retain the leases and if they reject the leases they will terminate the leases. If Rental Corporation terminates the leases then the landlord may assert an unsecure pre-petition claim in damages. As Rental Corporation was in default as at the time of the chapter 11 filing then it may not assume the lease unless it can cure the defaults and provide adequate assurance of future performance under the terms of the least (section 356(b) USC 11). Rental Corporation has 120 days after the voluntary petition date to elect between assuming or rejecting the leases (on the basis that it could assume them and cure the defaults). If Rental Corporation does not elect then it will be deemed to have rejected the leases. However, if 120 days is not long enough to make a decision then Rental Corporation can apply to the court for an additional 90 days for cause to make the decision.

The credit facility

Upon filing a chapter 11 plenary bankruptcy petition an estate is created over all of Rental Corporation's assets as of the petition date and an automatic stay comes into effect immediately upon filing. As such, whilst Rental Corporation has defaulted on its quarterly payment on it credit facility, the Lender of the credit facility will be prevented from initiating litigation on this default as it represents a pre-petition claim. Additionally, the Lender will be prevented from enforcing security, liens, or initiating setoff of any pre-petition debt and is also prohibited from any attempt to collect on pre-petition claims.

**Question 4.2 [maximum 5 marks]**

**Considering the facts set forth in Question 4.1, what protections does the Bankruptcy Code provide to lessors of office space to Rental Corporation?**

Pursuant to section 365(b) of USC 11 the landlord of office space to Rental Corporation do have protections as Rental Corporation may only assume the lease if it is able to cure or provide adequate assurance that it will promptly cure any monetary and non-monetary defaults with the lease and provides adequate assurance of future performance under the lease, as well as give the lessors of the office space to Rental Corporation sufficient assurances as to its future performace.

If Rental Corporation assumes the lease then Rental Corporation may remain in possession of the property, but the lease becomes a post-petition liability, with all its conditions, and the landlord has, effectively, a first-priority claim over Rental Corporation. Also, if Rental Corporation assumes the lease then it must remedy all outstanding defaults it owed to the lessor. The promptness of this remedy depends on the circumstances of the case but typically it is immediate. Further, if Rental Corporation assumes the lease and then subsequently defaults then no statutory caps on damages will apply (contrary to where it rejects the lease; see below).

If Rental Corporation rejects the lease then it will be in breach of the least of the date the lease is rejected. Rental Corporation must vacate the space and the lessors of the space can asset a "rejection damage" claim which will be a pre-petition unsecured claim sharing pro rata with other unsecured creditors. However, pursuant to section 502(b) of USC 11 the lessors' claim for future unpaid will be capped at one year's rent or 15% of the rent not to exceed three years; but, of course, it will be able to claim for the full amount of any unpaid pre-petition amount and any unpaid post-petition amount for rent would be an administrative priority claim.

If Rental Corporation does not vacate after rejection or post-assumption, and then it defaults on the rent, then the lessors are able to seek a stay of the Chapter 11 proceedings from the bankruptcy court which can then allow the lessors to pursue an unlawful detainer action to regain possession of the property.

**Question 4.3 [maximum 5 marks]**

**Paint Corporation formulates house paint according to proprietary and patented recipes at its factory in the United States, which it sells to home improvement stores under a number of distribution contracts. The US Environmental Protection Agency is investigating whether Paint Corporation’s operations are causing harmful chemicals to contaminate a nearby river. Paint Corporation is concerned it cannot afford the clean-up that may be required and is seeking to sell its business. Home Corporation is interested in buying the business, but does not want the potentially contaminated property (it can manufacture paint at its own factory) and is concerned about obtaining consent from all the home improvement stores to assign the distribution contracts. How would a sale under section 363 of the Bankruptcy Code address these issues?**

Whilst in most cases, Paint Corporation could deal with it property in the ordinary course of business and without the need for the court's consent or creditor input in a chapter 11 process, pursuant to section 363(b)(1) of the Bankruptcy Code it will also be allowed, with the benefit of a mandatory stay, to sell all, or substantially all, of its assets with the sanction of the court during chapter 11 bankruptcy proceedings.

Pursuant to section 363(b) of Chpt 11, Paint Corporation could apply for approval from the bankruptcy court to approve the sale of its business bar the potentially contaminated property to Home Corporation. The section 363 sale from Paint Corporation to Home Corporation must be carried out after at least 21 days' notice to creditors (including the US Environmental Protection Agency), and is subject to a court scrutiny and sanction.

Importantly, Paint Corporation's creditors' approval is not necessary for the court to approve the sale, but they would have the right to object to the sale. The court considers the "Lionel factors" when determining whether to approve a s.363 sale which includes, amongst other things, (i) the proportionate value of the assets to the estate as a whole, (ii) the elapsed time since the bankruptcy filing, and (iii) whether the asset is increasing or decreasing in value. Additionally, applying section 363(e), it may be the case that the court, exercising its discretion, may prohibit or condition the sale to Home Corporation "as is necessary to provide adequate protection" of any interests by any parties, including the US Environmental Protection Agency.

Pursuant to section 363(f) of Chpt 11, Paint Corporation may sell part of its business (i.e. all the business bar the property) and the sale, which is of key importance to Home Corporation, will be, pursuant to section 363(m), free of all third parties' claims to the sale assets if it is a good faith purchaser. Additionally, the sale of part of the business to Home Corporation can include the assignment of executory contract and unexpired leases between Paint Corporation and third parties, even if these contracts contain ipso facto clau*ses* or even covenants against assignment (pursuant to sections365(b)(2)(A) and 365(f)(1)*).*

Also, if approved by the bankruptcy court, it could sell the business bar the potentially contaminated property to Home Corporation pursuant to section 363(f) of the Bankruptcy Code free and clear of any security interest or liens. In this way Paint Corporation could sell its business to Home Corporation and use the proceeds of that sale to settle any debts it may have to the US Environmental Protection Agency.

It should also be noted that whilst there is no defined procedure for section 363 sales, it is the case that a practice has developed to conduct an auction with "stalking horse" bidders. In this case, Paint Corporation will need to market the asset it wishes to sell (i.e. the business without the property) and then will need to invite parties to consider purchasing this. If Paint Corporation are happy with Home Corporation's offer then it can seek to agree sale documents and have those approved by the court. If the court approves, the Home Corporation's bid will become the "stalking horse" for an auction which any other offer must beat in order to be selected. If another bid is accepted then it will likely be that Home Corporation will be paid a "break fee" but if no other bids beat Home Corporation's offer then the auction will be cancelled and its bid will be accepted.

Additionally, Paint Corporation should be way that its sale of substantially all of its assets to Home Corporation does not fall foul of the rule in *In Braniff Airwas, Inc.,* in which it was held that the court will not approve any asset sales where such a sale is seen as an attempt to short-circuit the requirements of chapter 11 for the confirmaiton of a reorganisation plan generally. As such, Paint Corporation will need to consider what other elements of its business will remain after the sale to Home Corporation and be able to put forward a positive reorganisation case regarding them.

**\* End of Assessment \***