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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?

1. The corporation must have its place of business in the United States,

or

1. The corporation must have assets in the United States.

These requirements may be met by minimal or intangible assets and eligibility to be a debtor is slightly broader under chapter 11 than it is under chapter 7.

**Question 2.2 [maximum 2 marks]**

What is an executory contract?

The meaning of an executory contract is not defined by statute, rather it has be derived from case law. An executory contract is a contract where there are material, unperformed obligations on both sides, i.e. actions by one party have only been partially undertaken and further performance is required, and the payment for those actions by the other party, has not yet been fully settled. Particular considerations need to be given to executory contracts under both chapter 7 and 11 proceedings as different time limits apply to decisions being made by the debtor in the performance and continuation of such contracts under each type of proceeding.

**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?

A priming lien is a lien which secures a post-petition credit extension which is senior or equal to (i.e. with the same priority) a lien already attached to some or all of the debtor’s property.

A priming lien is a ‘last resort’ option in securing DIP financing, and is only available when the debtor is not able to obtain any other types of unsecured credit. This will normally occur when the estate already has significantly encumbered assets and insufficient equity to support a junior lien. This type of lien is also only attainable if the debtor can demonstrate that the interest of the secured creditor being primed is adequately protected.

**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?

1. The class of creditors which are unimpaired by the reorganisation plan are deemed to have accepted the plan (because the rights of those creditors are not being altered by the plan).
2. A class of creditors is deemed to have rejected the plan when that class is to receive nothing under the plan.
3. A class of creditors is permitted to vote on a plan where those creditors are of an ‘impaired’ class (i.e. the plan will alter the rights of that creditor).
4. A class of creditors is deemed to have accepted the plan if a simple majority of the creditors, holding at least two-thirds of the value of claims in the class, vote in favour, or for equity interests, if two-thirds in amount of interests vote in favour.

**Question 2.5 [maximum 3 marks]**

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

Chapter 15 relates to recognition of a foreign proceeding by the US court, and once that recognition is granted, an automatic stay on certain actions comes into force, as it does under a Chapter 11 proceeding (for reorganisation). There are some differences between the automatic stays in these two different procedures however:

1. The automatic stay in a chapter 15 proceeding is subject to an exception which permits the filing of a plenary US bankruptcy proceeding even after the recognition of the foreign proceeding. By contrast, the automatic stay under a chapter 11 proceeding would prevent this.
2. Further the automatic stay under chapter 15 is granted on a discretionary basis by the US Court and only applies to the debtor’s property within the US. Under a chapter 11 proceeding, however, is automatic and worldwide.
3. Under a chapter 15 proceeding, the stay only arises once recognition has actually been granted (not at the point that the petition is filed) however, under a chapter 11 proceeding, the stay is automatic from the point the plenary bankruptcy proceeding is filed. It should be noted however, that under a chapter 15 proceeding, the bankruptcy Court has the discretion to grant an interim stay pending recognition or following recognition of a non-main proceeding.

**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?

Directors of Delaware corporations owe a fiduciary duty of loyalty to the “corporation’s best interest” and a duty of care in educated decision making in the ordinary course of business. Directors’ duties are owed to the corporation and to its shareholders, but not to the creditors, even in circumstances where the corporation is potentially insolvent and therefore, the shareholders are likely to receive nothing in the liquidation. Notably, and by contrast to other common law jurisdictions, Delaware Directors are protected from liability errors of judgement by the business judgement rule. Under this rule, the board of directors is presumed to have acted in good faith on the basis of reasonable information.

When a corporation is potentially or actually insolvent, and therefore operating in ‘the zone of insolvency’, the Delaware Supreme Court has held that directors do not owe any duties to creditors. This is significant and a contrast to other jurisdictions where the directors owe duties to the creditors at the point where the company is potentially insolvent. In the case of *North Am. Catholic Education Programming Foundation, Inc v Gheewalla*[[1]](#footnote-2), the Court held that “*individual creditors of an insolvent corporation have no right to assert direct claims for breach of fiduciary duty against corporate directors. Creditors may nonetheless protect their interest by bringing derivative claims on behalf of the insolvent corporation….*”. Accordingly, directors’ duties are only owed to the corporation (and its shareholders) even when the company is in the zone of insolvency and there is no equivalent to the concept of ‘wrongful trading’ under US law in the same way as there is in other common law jurisdictions.

**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.

The US bankruptcy courts are special federal courts created by legislation[[2]](#footnote-3), rather than the constitution, so have limited jurisdiction to enter into final orders other than on ‘core’ bankruptcy issues. The referral statute (28 USC §157 and §1334) distinguishes between ‘core’ and non-core’ matters and permits bankruptcy judges to hear and determine only core proceedings. The core proceedings which may be heard and determined for final order are included in the statute, listed (A) to (P) within the margin. At the outset of each motion or pleadings, parties must identify and state whether the matter at issue is core or non-core so that the bankruptcy court can determine the scope of its jurisdiction to render a final order.

The bankruptcy court may hear non-core proceedings if the matter is sufficiently related to the bankruptcy proceeding but it cannot make a final order on those matters. Instead, the bankruptcy court submits proposed findings of fact and conclusions of law to the District Court (to which interested parties may object) for the District Court’s final decision.

The 2011 decision of *Stern v Marshall[[3]](#footnote-4)* complicated matters further, where the Supreme Court held that even in core proceedings, a bankruptcy court cannot evade Article III jurisdiction. Subsequently, Supreme Court rulings and amendments to the Bankruptcy Rules have assisted in clarifying position. The US Supreme Court has held that a bankruptcy judge may determine a core proceeding over which they lack constitutional authority by issuing a report and recommendation for review by the district court, the same procedure which applies in non-core proceedings, or, with the consent of the parties, they may issue a final order.

Appeals from the bankruptcy court are heard by the district court for the district in which they sit. In certain circuits however, bankruptcy appeals are heard by the Bankruptcy Appellant Panel (BAP), although in those circuits, the appellant is able to request that the appeal be heard by the district court instead.

As to reviews of non-final orders, where the ruling of the bankruptcy court was in a non-core proceeding or the bankruptcy court otherwise did not have authority to enter into a final order, the district court of the BAP reviews de novo all findings of fact and conclusions of law to which a party has objected. The order of a district court of BAP is then reviewed by a circuit court of appeal de novo to conclusions of law and for abuse of discretion for findings of fact.

**Question 3.3 [maximum 4 marks]**

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

A preference, a fraudulent conveyance and a constructive fraudulent conveyance are three different types of transaction which are vulnerable to being clawed back in the liquidation proceeding if they occurred within certain circumstances and timeframes. Preferences, and the recovery of preferences is focussed on the transactions that occurred immediately prior to the bankruptcy, other transactions within a two-year period prior to the date of the bankruptcy petition may also be avoided if they constitute a ‘fraudulent conveyance’. Further, transactions may also be avoided based on being a ‘constructive fraudulent conveyance’ but without having to show fraudulent intent.

1. A **preference** is a transfer of the debtor’s property made in a specified period before the petition date that must be returned to the estate if it exceeds the value that the recipient/creditor would have received by way of a chapter 7 liquidation and had the transfer not been made. Notably, in a claim for the recovery of a preference there is no requirement to show any fault of either the debtor or the recipient in connection with the payment being made and the recipient creditor is not penalised other than being required to return the asset. This is a contrast to other jurisdictions where often there is a requirement to show an ‘intent to prefer’. The avoidance of a preference is intended to preserve fair treatment between similarly placed creditors and to prevent a race to collect from the distressed debtor. Preferences only arise where the debtor is paying the creditor for a pre-existing debt, so contemporaneous exchange of value is not a preference.
2. A **fraudulent conveyance** is proven by showing that the debtor made a transfer or incurred an obligation “with actual intent to hinder, delay, or defraud any entity to which the debtor was or became…indebted”. A debtor may expect to become indebted when it anticipates liability under a money judgement, settlement, penalty, or similar obligation arising from violation of state or federal securities law or fraud, deceit, or manipulation in the sale of a registered security. Intent may be proven circumstantially, by reference to “badges of fraud”.
3. A **constructive fraudulent conveyance** is proven by showing that i) the debtor received less than reasonably equivalent value in exchange for a transfer or incurrence of obligation and ii) one of the following additional factors:

* The debtor was insolvent at the time or became insolvent due to the transaction;
* The debtor was unreasonably capitalised for the transaction;
* The debtor intended to or believed that it would incur debts beyond its ability to pay;
* The transfer was made to or for the benefit of an insider or was outside the ordinary course of business.

Significantly, with a constructive fraudulent transfer (and by comparison to a fraudulent conveyance) the recipient of the transfer may retain the property or may enforce the obligation created and in good faith, unless the transfer would be avoidable as a preference, statutory lien or unperfected security interest.

**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?

A Chapter 15 application is used by a foreign representative to seek recognition of a foreign insolvency proceeding in the United States. Where recognition of a valid foreign proceeding is sought, it needs to be determined whether that proceeding is the foreign ‘main’ proceeding, or ‘non-main’ proceeding. Determining which category, the case falls into will impact the scope of the relief that is available by way of the US Bankruptcy Court and merely filing the chapter 15 petition, does not automatically invoke a stay of creditor action.

The requirements for the recognition application itself are minimal, however, issues can arise when the proceeding is categorised as either the main or non-main proceeding. Under the UNCITRAL Model Law, a foreign main proceeding is a proceeding that is commenced in the debtor’s Centre of Main Interest “COMI”. This concept is not a US law definition, rather the US courts typically use the concepts of ‘domicile’, ‘principal place of business’ and ‘the location of assets’ in order to determine jurisdiction and venue. The bankruptcy court, however, will use COMI and the principles underpinning this concept, in order to make a determination as to whether it is a ‘main’ or ‘non-main’ proceeding.

A debtor’s COMI is said to be its place of incorporation, however, this is a rebuttable presumption and additional relevant factors include the location of headquarters, management and the primary assets. Additionally, the location of the majority of the debtor’s creditors, or the location of the majority that will be affected by the relief requested by the foreign representative. Finally, the jurisdiction that will apply to most of the disputes will also have bearing. A debtor’s COMI should also be ascertainable by its creditors or other third parties, which relies on objective evidence.

Foreign insolvency proceedings in any other jurisdiction, in relation to the chapter 15 application, but which is not where the debtor’s COMI is, would be recognised as a ‘non-main’ proceeding. To be recognised as a non-main proceeding however, the debtor still had to have carried out some form of business activity in that jurisdiction and/or have an establishment there prior to the commencement of the chapter 15 application. A country which was only used as a ‘post box’, with only say a bank account and a registered office but with no staff and actual operations, may not be recognised as a foreign non-main proceeding.

The *Bear Stearns[[4]](#footnote-5)* case is a good example of both of these concepts and principles being applied by the US Court. In that case, the US bankruptcy court held that the Cayman Islands could not be the COMI for a Cayman-Incorporated hedge fund, because the fund was set up as an ‘exempted’ company and licenced in accordance with Cayman Law, on the basis that it did not actually carry out any business operations in that jurisdiction. The court also found that the Cayman liquidation could not even be recognised as a non-main proceeding because the Debtor had no establishment in Cayman prior to the insolvency.

This case also highlights an important principle of the US bankruptcy court in determining COMI, which is that the location of COMI is to be assessed as at the date of the US petition rather than the commencement of the foreign proceeding. This practice has led to foreign representatives actively shifting the COMI through the conduct of the foreign proceeding and moving the books and records of the company, appointing local agents to consolidate the assets and holding meetings with management and creditors for some months prior to making the Chapter 15 petition in the US. As a result of these practices and the conflict created with the US Bankruptcy Court practices, the UNCITRAL Working Group have prepared an implementation manual for the Model Law which specifies that COMI is to be tested based on the date of commencement of the foreign proceeding to deal with the concerns about the debtor’s COMI being manipulated 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?

Firstly, and from the moment that the chapter 11 petition to commence the proceedings is filed, there is an automatic world-wide stay preventing the enforcement of any creditor actions against Rental Corporation (“RC”). The purpose of this stay is to provide breathing space for RC to formulate a reorganisation plan and to restructure its debt. The scope of the stay is extremely broad, prohibiting litigation on pre-petition claims, any act to obtain possession of RC’s property. Accordingly, and in respect to the (ii) securities class action litigation, this will be stayed and will not be enforceable whilst the chapter 11 proceeding is conducted. This stay however, is subject to some statutory exceptions and those which are of relevance to this case are criminal proceedings and regulatory investigations. Accordingly, the (i) DOJ investigation will continue to proceed and will not be prevented by way of the chapter 11 proceeding.

The leases over the office spaces would be considered executory contracts, which is a term not defined in statute, however, through case law a contract is deemed to be executory where there are material unperformed obligations on both sides. In this instance there are lease agreements which have not yet expired; accordingly, these contracts are not yet complete. By operation of the chapter 11 proceedings, a debtor would normally have until confirmation of the reorganisation plan as to whether it intends to assign, assume or reject any executory contracts. The (iii) delinquent lease agreements, however, are an exception to this rule and RC will be required to make a decision about the lease agreements of the office spaces within 120 days of the order of relief. This period can be extended to 90 days by RC for cause, however, any extension requires the consent of the lessor (11 USC § 365(d)(4)). It should also be noted that if the leases are still tenanted with RC’s tenants and those tenants are still paying rent, then it may be worthwhile for RC to preserve the lease agreements because they are potentially still returning an income which can be factored in as part of the restructuring plan. This would also be in the lessors’ best interests as it may be the most likely way for them to recover some money back.

As to the credit facility, whether or not the facility is a secured or unsecured creditor, the automatic stay will prevent the lender from enforcing its security against RC in order to recover the debt owed to it, as this will now need to be resolved by way of the restructuring plan. It may be in the lenders best interests to actually encourage or support the plan as it may be a better solution to recovering more of the debt owed it, particularly if the company has the ability to become profitable if properly run. Whilst the credit facility cannot bring an action to recover its debt, it will not be required to continue to advance funds to RC pursuant to the facility. Any further financing to be acquired by RC (or by the trustee possibly appointed to run RC in place of allegedly fraudulent management) for the purpose of financing the chapter 11 restructuring will need to be first approved by the court.

**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?

The owners (lessors) of the building rental corporation are able to seek relief from the automatic stay, in certain circumstances (listed below) and even though such creditor actions would normally be prohibited. They can do this either through a lift-stay motion, or relief from stay motion.

1. The first circumstance within which they could apply for relief is if they have a lack of adequate protection in respect to their interest in the property of RC (which a lessor commonly does as their interest is not secured in anyway), and where there is a risk that the value of the property may decline as the proceedings continue and result in the lessors making a less than full recovery in respect to their unpaid rents. This is is very possible given the high costs of a chapter 11 proceeding and the fact that there is evidence of fraud. In order to determine this, the court will look at the value of the lessor’s interest in the property, which presumably will be low because what is owed to the lessors is unpaid rent and they do not necessarily have any secured interest in RC’s property. The second element which will then be considered is the value of the lessor’s claims, which will continue to increase as time goes on and as they continue to remain unpaid for the outstanding rent. The value will normally be determined by the Court looking at the contract, which in this case will be the lease agreement.

If the court determines that there is inadequate protection for the lessors, then the the stay may be lifted to allow the lessors to pursue remedies with respect to the property only if it provides ‘indubitable equivalent’ of the value that may otherwise be lost. In other words, an equal security over what the lessors are owed. This is normally achieved by way of either periodic cash payments (which may or may not be possible for RC) or through the grant of a replacement lien on unencumbered property of RC. Again, and based on the facts, it is not clear what further property or assets RC owns that could be useful here. Section 361 sets out the options for providing adequate protection and section 362(d) is authority for recording the lien interest in the state property register. If the Court orders this relief and it is not sufficient, the shortfall is then given administrative expense priority.

1. A further circumstance which would provide grounds for the lessors to seek relief from the court, is where RC has no equity in the property, and it is not necessary for reorganization. Whether this circumstance will be applicable or not will depending on the reorganization plan and whether RC will try to retain the lease agreements. In this circumstance, the lessors will also need to show that value of its interest in the property, exceeds the value of the property. If RC demonstrates that the leases are a crucial part of its business remaining profitable and being able to restructure, this may be a more difficult circumstance to rely on.
2. A third circumstance is where the sole asset of the RC is a single piece of real property encumbered by an interest of the lessors, and RC has not (i) filed a plan within 90 days, or (ii) made monthly payments at a non-default contract rate of interest, then the stay should be lifted to permit the creditor to foreclose or pursue other non-bankruptcy measures. This will not be an applicable circumstance in the case of RC and the lessors because the RC does not own the property and we are not clear on what real property it actually possesses (if any).
3. Finally, if a creditor is secured by real property, and the court finds that RC’s chapter 11 filing “was part of a scheme to delay, hinder, or defraud creditors that involved either a) transfer of all or part ownership of, or other interest in, such real property without the consent of the secured creditor or court approval, or b) multiple bankruptcy filings affecting real property”.

The court may also terminate a stay as of a set future date, annul the stay retrospectively (validating acts that otherwise would have been void or voidable as stay violations), modify the stay to permit a specific act, or condition the continuation of the stay on RC’s compliance with a condition to protect the lessor’s interest in the property, in each case for cause shown.

Finally, it should be noted that in order to provide any of the relief described in respect to the automatic stay, this can only occur after notice and a hearing before the court, although this requirement is deemed to be satisfied if notice is given and there is no opportunity for a hearing or if no one objects to the relief. If there is insufficient time before a certain act must be taken, then at the court’s discretion, it can also waive the requirement to the hearing.

**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?

A Chapter 11 proceeding allows a debtor in possession to continue to operate its business whilst also carrying out a restructuring and this process is now commonly used as a vehicle for the sale of substantially all of the debtor’s assets. Because the business can continue to operate whilst the process is underway and the business is protected by the automatic stay imposed, the sale price of the assets is normally higher (as the business is still able to continue as a going concern). This will be particularly crucial for Paint Corporation (“PC”) in circumstances where the value of its business may decline due to the potential contamination that its paint production is causing and if it is forced to cease trading in respect to the profitable part of the business. Accordingly, being able to separate the profitable business operations from the potentially contaminated land/physical operations will be crucial to maintaining value in the company for the purposes of a sale to Home Corporation (“HC”).

Accordingly, and in order to achieve this effectively and without the threat of creditor action, PC should consider restructuring the business by way of a Chapter 11 proceeding, whereby PC would become a “debtor in possession”. A chapter 11 proceeding will allow the business to carry on in the ordinary course, whilst also invoking an immediate stay on creditor actions and will give PC some ‘breathing space’ to reorganise its business operations so that it is able to sell off parts of the operations to HC and then separately deal with the (potentially) contaminated land/manufacturing plant.

Under a Chapter 11 proceeding, and subject to Court approval, a debtor in possession can then carry out a section 363 sale of an asset. This type of sale allows the asset to be sold free and clear either i) with creditor consent, ii) where the creditor interest is disputed or iii) where the value of the property exceeds the value of the interest. In such circumstances a creditor’s interest will attach to the proceeds of the sale and it will receive priority in distribution of those proceeds. Accordingly, a 363 sale can often be a preferred solution for both the debtor and the purchaser as the bankruptcy sale is free and clear of creditor interests.

Because HC would like to buy the ‘operational’ part of the business, being the patents and proprietary recipes, and the distribution contracts a 363 sale may be an appropriate route to take because PC can transfer its interest in key contracts that are required to operate the business even where those contracts contain restrictions as to assignment or purport to terminate upon bankruptcy filing. Furthermore, licensees of patents owned by PC are protected such that their licences may not be terminated in connection with the sale of that intellectual property, without PC’s consent.

As a debtor in possession, PC will be free to sell the estate property in the ordinary course of business and previous court decisions have developed a two-pronged test to ensure that a balance is struck between normal business operations and operating the business in a way that normally considers and benefits a creditors interest. Accordingly, in selling the different parts of the business, PC will need to consider the ‘vertical dimension’ being the expectations of a hypothetical creditor and the horizontal dimension, (how the business is conducted by other businesses similar to the debtor). A particular transaction is considered to be “in the ordinary course” if it can satisfy both elements of the test. PC should also note however, that its right to deal with the business assets “in the ordinary course” will not trump provisions requiring adequate protection of other’s interests in the estate property.

If it is deemed that the proposed transaction(s) (of selling the operational part of the business to HC) is not in the ordinary course of business, PC will need to establish that it is proposing the transaction in its business judgement. This then triggers PC’s fiduciary duty to consider the interests of its creditors, and to ensure that the sale is in the best interest of the estate as a whole. The UCC (Unsecured Creditors Committee) will often be closely involved with scrutinising the transaction and is authorised to retain financial advisors (at PC’s expense) to assist it. The bankruptcy code does not specify a set procedure for 363 sales, although a large business with significant sales will be conducted via an auction with a “stalking horse” bidder. PC may want to seek assistance form a financial advisor to assist them in marketing the property and to see whether there are any other interested parties in addition to HC who may want to conduct due diligence. This process may ultimately result in negotiations with HC as the only interested party, however, if there are other interested parties it can help to increase the value and it will demonstrate to PC’s creditors that it has tried to maximise the sale and ensured that it has marketed the sale properly.

Given the nature of PC’s circumstances, with concerns about the land and the need to be able to sell the profitable part of the business as soon as possible and separate from the land, an auction approach may not be necessary in circumstances where it has a interested and suitable buyer and where it may not want to draw attention to the fact that it is being investigated by the US Environmental Protection Agency, as this could in fact jeopardise the sale price.

**\* End of Assessment \***

1. 930 A.2d 92 (Del 2007) [↑](#footnote-ref-2)
2. The 1978 Bankruptcy Code (rather than Art III of the Constitution) [↑](#footnote-ref-3)
3. 564 US 462 (2011) [↑](#footnote-ref-4)
4. 374 BR 122 (Bankr SDNY 2007) [↑](#footnote-ref-5)