



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: [studentID.assessment3A]. An example would be something along the following lines: 202223-336.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 "student number" 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.**
- 6.1 **If 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 2023. The assessment submission portal will close at 23:00 (11 pm) GMT on 1 March 2023. 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 2023 or by 23:00 (11 pm) BST (GMT +1) on 31 July 2023. If you elect to submit by 1 March 2023, you may not**

submit the assessment again by 31 July 2023 (for example, in order to achieve a higher mark).

7. Prior to being populated with your answers, this assessment consists of 9 pages.

**ANSWER ALL THE QUESTIONS**

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

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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**

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Which of the following entities does not satisfy the minimum presence requirement to be a debtor under any chapter of the Bankruptcy Code?

- (a) A foreign domiciled company that pays a US attorney a retainer.
- (b) A company with several US bank accounts, but no physical presence in the United States.
- (c) A company with US patents, but no physical presence in the United States.
- (d) All of the above satisfy the minimum requirement for presence in the United States.**
- (e) None of the above satisfy the minimum requirement for presence in the United States.

**Question 1.2**

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ABC Corp is an industrial manufacturing company that is filing for bankruptcy. Which of the following could not be considered a party in interest?

- (a) A neighboring landowner to ABC Corp's manufacturing plant.
- (b) An environmental advocacy group that opposes ABC Corp's operations.**
- (c) The landlord of ABC Corp's corporate office.

- (d) *People who live several miles downstream from ABC Corp's manufacturing plant and have been exposed to the plant's toxic waste.*
- (e) *The US Internal Revenue Service.*

Question 1.3

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*Which of the following contracts to which ABC Corp is a party is executory and may be assigned without counterparty consent?*

- (a) A lease on a manufacturing plant that contains a provision that requires landlord approval of any assignment.**
- (b) *An employment contract between ABC Corp and a former employee, requiring the company to provide health insurance through the end of the current year.*
- (c) *A 10-year software licensing agreement with XYZ Corp that is three years into performance.*
- (d) *A lease on office space that ended the prior year, but for which ABC Corp still owes past rent.*
- (e) *None of the above are executory and may be assigned without counterparty consent.*

Question 1.4

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*Which of the following conditions must be true about a reorganization plan for a court to confirm it under Chapter 11 proceedings?*

- (a) *Have a possibility of success, even if it relies on speculative or improbable events to be capable of execution.*
- (b) *The plan is not likely to be followed by liquidation.*
- (c) *All impaired classes must accept the plan.*
- (d) *All of the above.*
- (e) None of the above.**

Question 1.5

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*Which of the following about cramdowns, is false?*

- (a) *The plan of reorganization must be fair and equitable to all impaired classes.*
- (b) *Differential treatment of different classes is permitted if there is a reasonable, good faith basis for doing so and such treatment is required for the plan of reorganization to be successful.*
- (c) *Class definition is often a battleground when a debtor tries to cramdown classes.*
- (d) *Dissenting creditors are permitted to challenge the classification of a creditor supporting the cramdown.*
- (e) *If one insider creditor approves of the plan of reorganization, all other impaired classes may be crammed down.*

Question 1.6

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Which of the following about 363 sales is false?

- (a) *A good faith purchaser at a 363 sale may retain the property notwithstanding a subsequent reversal of court approval for the sale on appeal.*
- (b) *The debtor in possession must establish that the transaction is in the best interests of the estate as a whole.*
- (c) *In chapter 15 proceedings, a foreign court's approval alone suffices for a 363 sale.*
- (d) *Debtors must carry out a robust marketing process for the sale.*
- (e) *A creditor's lien on assets sold in a 363 sale attaches to the proceeds of the sale.*

Question 1.7

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Which of the following is true of both an actual fraudulent conveyance and a constructive fraudulent conveyance?

- (a) *The debtor must have had an actual intent to hinder, delay, or defraud any entity to which the debtor was or became indebted.*
- (b) *Both require at least circumstantial evidence of the fraudulent intent.*
- (c) *The debtor must have been insolvent at the time of transaction.*
- (d) *In addition to provisions in the Bankruptcy Code, the debtor or the trustee may invoke applicable state or foreign fraudulent conveyance laws.*
- (e) *All of the above are true.*

Question 1.8

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*When does an automatic stay come into effect?*

- (a) Immediately on the filing of any plenary petition.**
- (b) *On the filing of a voluntary petition but not on the filing of an involuntary petition.*
- (c) *Once the court reviews the petition and grants the stay.*
- (d) *Once the petitioner announces their intention to file for bankruptcy publicly.*
- (e) *Once a plan of reorganization is confirmed.*

Question 1.9

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*Which of the following regarding substantive consolidation is true?*

- (a) *It respects the boundaries of corporate separateness.*
- (b) *It is the treatment of two or more creditors as a single creditor to simplify the claims process.*
- (c) If a creditor can show it extended credit on the basis of corporate separateness, it has a valid objection to substantive consolidation.**
- (d) *Substantive consolidation is commonly used to resolve bankruptcies of corporate groups.*
- (e) *Authority for substantive consolidation comes from the Bankruptcy Code.*

Question 1.10

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*Which of the following are relevant factors in determining a debtor's center of main interests (COMI) in the recognition stage of a Chapter 15 bankruptcy case?*

- (a) *The location of the headquarters.*
- (b) *The location of primary assets.*
- (c) *The location of the majority of the affected creditors in the request for relief.*
- (d) *The jurisdiction whose law will apply to most disputes.*
- (e) All of the above.**

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

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**Question 2.1** (1 mark)

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**What is setoff and why is it not permitted in many circumstances?**

*Setoff allows a creditor who has a claim against a debtor and owes money to that debtor to "net out" those obligations. Pursuant to section 362(a) of the Bankruptcy Code, the automatic stay also applies to the setoff between any debt arising prior to the opening of proceedings and any pre-petition claim of the debtor. Except for specific transactions, pursuing setoff rights is not allowed in several contexts. This is because the exercise of such rights can improve the creditor's position when compared to other unsecured creditors not owed money by the debtor. It reduces the creditor's obligation towards the estate by the full amount owed by the debtor as compared to the lower amount that the latter would pay for the unsecured claim. Setoff rights are not permitted in the following situations: the claim of the creditor is disallowed, the creditor's claim was acquired after the filing of the petition or in the 90 days before the filing when the debtor was insolvent, the creditor's obligation arises in the 90 days before the filing of the petition when the debtor was insolvent with the scope of pursuing setoff rights, and the creditor's position is enhanced via setoff as compared to the position of the same creditor had the setoff been exercised 90 days before the petition.*

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**Question 2.2** [2 marks]

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**What rules should you review when preparing a filing for a bankruptcy court?**

*When preparing a filing for a bankruptcy court the following rules should be reviewed: the Federal Rules of Bankruptcy Procedure (i.e. "the Bankruptcy Rules"), the Federal Rules of Civil Procedure, the local rules applying to the relevant bankruptcy court as well as the personal practices of the judge concerned. It might be useful to contact a local practitioner in case of unwritten rules and practices within the local context. Generally speaking, a review of applicable foreign law, non-bankruptcy law and relevant case law might be of assistance for the proceeding itself.*

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**Question 2.3** [2 marks]

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**What does the absolute priority rule require and when can it be deviated from?**

*In accordance with the absolute priority rule, no creditor or class of creditors may acquire less under a reorganization plan than it would under a liquidation pursuant to Chapter 7 of the US Bankruptcy Code. In those liquidation proceedings the claims would be satisfied in accordance with the priorities required by law without the affected creditor's consent. Specifically in the context of distribution of assets in a Chapter 7 liquidation, the absolute priority rule requires the payment in full of a certain*

category of claims before the subsequent category receives any payment. Therefore, in a Chapter 7 procedure, statutory priorities should be followed without the possibility of any deviation. Nevertheless, deviation is possible in a Chapter 11 reorganization proceeding subject to affected creditors' consent. In a Chapter 11 reorganization plan it is possible that a "more senior creditor" agrees with obtaining less than the absolute priority rule would demand. This is possible in case funds should be distributed to lower priority creditors in order to secure their approval of the plan.

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In addition, certain employee expenses (mainly, unpaid salaries and contributions regarding employee benefit plans of 180 days before the date of the petition or cessation of business operation) retain administrative priority in a Chapter 7 liquidation. Under the absolute priority rule, those expenses cannot be treated less favourably in a plan than they would be treated in a Chapter 7 proceeding, unless consent is given by the employees. It is important to note that in a "Chapter 11-subchapter V" reorganization plan (in the context of the 2019 Small Business Reorganization Act) the absolute priority rule doesn't apply, thus allowing the debtor to preserve its equity in the reorganized business while not paying all creditors in full. Of course, for the confirmation of a cramdown plan, all estimated disposable income should be used within a period of three to five years so to make payments under that plan.

Question 2.4 [2 marks]

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

With respect to post-commencement financing of a debtor in Chapter 11 proceedings, it is possible for the court to grant, inter alia, a priming lien. The priming lien should be superior or equivalent to a pre-petition lien over property of the estate in order to guarantee post-commencement financing. The secured creditor's priority is being superseded by another creditor's priority status and, therefore, the debtor must show that the secured creditor's interest is adequately protected as well. Because of the nature of the risk of being "primed", creditors frequently choose to continue granting credit to the debtor.

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Question 2.5 [3 marks]

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**What is a preference? What are the elements of a preference claim that need to be proved? Is a showing of fault, by either the debtor or creditor, required?**

Preferences are regulated by Section 547 of the Bankruptcy Code (Title 11, U.S. Code). If a transfer of property occurs during the period prior to the filing of the petition, that transfer is considered a "preference" that should be returned to the insolvency estate. The transfer should be greater in value than the amount acquired by the recipient in a hypothetical Chapter 7 liquidation proceeding. The inherent scope of preference

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avoidance provisions is to treat in the same manner creditors who are in a comparable position. In addition, it discourages instances of "creditors' race" to recover money from the debtor. The recipient of the transferred amount that has been avoided receives an unsecured claim.

In order to establish a preference certain elements shall be present. First of all, it should be a transfer concerning a debtor's interest in the property such as funds, assets or interest in property. If the debtor does not have an interest in the property then this is not considered a preference (e.g. where the debtor holds an asset as an 'agent' on behalf of another person). Secondly, the transfer should specifically benefit the creditor. If the recipient does not act as a creditor of the debtor then the transfer cannot be characterized as preference. Rather, fraudulent conveyance provisions may apply for this recovery. Thirdly, the transfer should be linked to an already existing debt. Therefore, any 'contemporaneous exchange of value' (see 11 USC, § 547(c)(1)) and any sort of prepayment regarding goods and services are not preferences. It is important to underscore the utility of examining non-bankruptcy law to assess the timing of both the debt and the transfer. In case of a security interest, the date of the transfer is deemed to be the date of its perfection. This is true if that perfection happened at least 30 days following effectiveness of the transfer between the parties (see 11 USC, §547(e)). However, if perfection is delayed, it is possible for the transfer to be considered not contemporaneous and thus the date of the transfer may be postponed to the preference period. Moreover, the filing of any plenary petition will stay any perfection of a security interest rendering it unenforceable. Fourthly, the transfer should occur during insolvency of the debtor. During the ninety days before the petition date the debtor is presumed insolvent, a presumption that is rebuttable by evidence brought by a creditor. The ultimate burden of proving, on the basis of the balance sheet test, that the debtor was insolvent when the transfer was made is on the debtor or the trustee. Another element to establish a preference is that the transfer should have taken place during the suspect period. The suspect period for transfers involving third-parties is calculated at 90 days before the petition date, while the suspect period involving insiders is calculated at one year before the petition date. Of course, no presumption of insolvency is established for the period between one year and 91 days before the petition. Lastly, the transfer should allow the creditor to improve its status, something that can be shown when comparing its position with a hypothetical Chapter 7 liquidation in which the transfer does not take place.

Moreover, there is no requirement for proof of fault on the part of either the debtor or the beneficiary. Indeed, the recipient, except for eventually prejudgment interest, is only obliged to return the property transferred.

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

**Question 3.1** [3 marks]

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

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After the US Supreme Court abolished the provisions relating to jurisdiction within the 1978 Bankruptcy Code, new provisions were enacted on those matters. Those provisions grant jurisdiction over bankruptcy proceedings to district courts and allow the latter to refer bankruptcy proceedings to their district's bankruptcy courts.

This referral statute distinguishes among core and non-core issues. Bankruptcy judges are allowed to hear and determine core matters only. Section 157 (see 11 USC, §157) comprises a non-exhaustive list with respect to core proceedings. Concerning non-core matters, these can be heard by the bankruptcy court. The bankruptcy court, however, has to be satisfied that those proceedings are appropriately linked to a bankruptcy proceeding. The bankruptcy court is, in this case, not allowed to make a final decision. Rather, for a final decision to be taken by the district court, factual findings and conclusions of law should be submitted by the bankruptcy court to the district court in which objections by parties are permitted.

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It is, nonetheless, important to examine US case law on this matter. For instance, in the *Stern v Marshall* case (564 US 462 (2011)), the US Supreme Court held that final orders pursuant to core matters of a bankruptcy court cannot be issued encroaching on Article III jurisdiction. Further legislative and jurisdictional guidance shed light to the already ambiguous environment of bankruptcy court jurisdiction. It is, for instance, also possible for a bankruptcy court to exercise the delegated power of the district court to issue a final order regarding a motion contesting the validity of a petition opening a bankruptcy proceeding (as the district court has exclusive jurisdiction to adjudicate a petition opening those proceedings). In *Executive Benefits Ins. Agency v. Atkinson* (134 S. Ct. 2165 (2014)), the US Supreme Court stated the possibility for bankruptcy judges to issue recommendation and a report to be reviewed by the district court determining a core proceeding over which bankruptcy judges lack constitutional authority. In *Wellness International Network, Ltd. v. Sharif* (135 S. Ct. 1932 (2015)), the US Supreme Court held that bankruptcy judges may issue final orders with parties' consent. Nowadays, the Bankruptcy Rules require from the parties to indicate in their pleadings whether they consent to the bankruptcy court issuing a final order or judgment (see Fed. R. Bankr. P. 7008). In addition, Federal Rule 8018.1 (see Fed. R. Bankr. P. 8018.1) stipulates that "[i]f on appeal, a district court determines that the bankruptcy court did not have the power under Article III of the Constitution to enter the judgment, order, or decree appealed from, the district court may treat it as a proposed findings of fact and conclusions of law".

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The district court hears appeals from bankruptcy court orders. Specific circuits, however, (namely the First, Sixth, Eighth, Ninth and Tenth) have chosen (see 28 USC, §158(d)) to develop Bankruptcy Appellate Panels (BAPs). These BAPs, whose composition is established by the circuit's judges of the bankruptcy courts, deal with bankruptcy appeals. Nevertheless, in those circuits, a party may request that the district court hears the appeal. Orders from a district court or BAP may be heard by the appeal circuit court. It is also possible that an appeal from a bankruptcy court reaches directly the appeal court. The district court or bankruptcy court should certify that "i)

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the judgment, order, or decree involves a question of law as to which there is no controlling decision of the court of appeals for the circuit or of the Supreme Court of the United States, or involves a matter of public importance; (ii) the judgment, order, or decree involves a question of law requiring resolution of conflicting decisions; or (iii) an immediate appeal from the judgment, order, or decree may materially advance the progress of the case or proceeding in which the appeal is taken" (see 28 USC, § 158(d)). The court of appeals may or may not authorize the direct appeal of a case so certified.

With respect to the standard of review for non-final orders, the ruling may be linked to noncore proceedings or simply the lack of authority of a bankruptcy court to enter a final order. In this case, either the Bankruptcy Appellate Panel (i.e. the 'BAP') or the district court reviews from the beginning findings of fact and conclusions of law to which a party has expressed objections. An appeal circuit court reviews the district court's or the BAP's order from the beginning concerning conclusions of law and abuse of discretion with respect to factual findings.

Question 3.2 [3 marks]

**What provisions of the Bankruptcy Code automatically apply to the debtor's property within the territorial jurisdiction of the United States upon recognition of a foreign main proceeding? What relief may be granted on a discretionary basis for either foreign main or non-main proceedings?**

Upon recognition of a foreign main proceeding, specific provisions of the US Bankruptcy Code apply to the debtor's assets that are situated in the territorial jurisdiction of the United States. First of all, subsection 1520(a) (see 11 USC, § 1520(a)) cross-refers to section 361 on adequate protection and section 362 on the automatic stay. It is important to note that "the right of a foreign representative or an entity to file a petition commencing a case under this title or the right of any party to file claims or take other proper actions in such a case" is in any event permitted (see 11 USC, § 1520(c)). Secondly, unless otherwise decided by the court, the foreign representative is entitled to operate in the ordinary course the business of the debtor (see 11 USC, § 1520(a)(3)). The foreign representative, unless otherwise decided by the court, is vested with the rights and powers of a US trustee for matters relating to sections 363, regarding the 'use, sale, or lease of property', and 552, regarding the 'postpetition effect of security interest'. Indeed, pursuant to section 552, avoidance may be sought in respect of the perfection of a security interest in the debtor's property after the petition date. Moreover, transfers that took place after the petition date can also be avoided pursuant to 11 U.S.C. § 549. In accordance with section 363, the foreign representative may sell, use or transfer debtor's property outside the ordinary course of business. In addition, "upon recognition of a foreign proceeding, the foreign representative may intervene in any proceedings in a State or Federal court in the United States in which the debtor is a party" (11 USC, § 1524).

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All the aforementioned circumstances linked to a foreign main proceeding may also be available in the context of a foreign non-main proceeding on the basis of discretionary relief. Upon recognition of either a main or non-main foreign proceeding, discretionary relief may also be granted if it refers to the following specific measures (see 11 USC, §1521). Firstly, discretionary relief may relate to authorizing the discovery of the debtor's property and affairs (" [...] providing for the examination of witnesses, the taking of evidence or the delivery of information concerning the debtor's assets, affairs, rights, obligations or liabilities" [...], see 11 USC, §1521(a)). Secondly, relief may concern entrusting the administration of the debtor's assets, that are situated in the United States, to the foreign representative or another person, "provided that the court is satisfied that the interests of creditors in the United States are sufficiently protected" (see 11 USC, § 1521(b)). Thirdly, relief may also refer to any extension of relief already granted in accordance with section 1519(a) on an interim (provisional) basis. Lastly, relief on a discretionary basis may concern any relief necessary and available to a US trustee and especially one that would fulfill the scope of a Chapter 15 proceeding while preserving the interests of creditors and the assets of the debtor. For the purpose of granting additional assistance, it might be useful to also examine section 1507(b) in which specific factors are listed alongside the principles of comity. Pursuant to section 1521(c), with respect to discretionary relief of a non-main proceeding, the bankruptcy court must be satisfied as to the appropriateness of the administration of assets located in the United States by the foreign non-main proceeding. Moreover, there is a significant difference in the level of protection afforded in foreign main proceedings compared to that of foreign non-main proceedings, which appears to be lower. In fact, section 1522 enables the bankruptcy court to discontinue discretionary relief granted upon request of an interested party and to "subject relief granted under section 1519 or 1521, or the operation of the debtor's business under section 1520(a)(3), to conditions it considers appropriate, including the giving of security or the filing of a bond" (see 11 USC, § 1522).

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**Question 3.3** [4 marks]

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**What duties do directors owe to a Delaware corporation in the ordinary course of business? To whom are these duties owed when the corporation is potentially or actually insolvent? What rule protects directors from liability for errors of judgment?**

In the context of a company incorporated in Delaware, the issue of a director's liability should be assessed in light of the relevant state law of the state of incorporation (Delaware). It is important to note that Delaware is considered an important jurisdiction in the territory of the United States with respect to corporate law. Several US jurisdictions have been influenced by the law of Delaware for their corporate laws. During the ordinary course of business, directors, first of all, have a fiduciary duty of loyalty in connection with the best interests of the corporation. Secondly, they owe a duty of care in the context of proper decision-making.

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The foregoing duties concern directors vis-à-vis the corporation and its shareholders. These duties are not owed to creditors even if the debtor is on the brink of insolvency ('potentially insolvent') and the shareholders are likely to receive nothing. A notable case, *North Am Catholic Educational Programming Foundation, Inc v Gheewalla* (930 A.2d 92, 103 (Del 2007)), issued by the Delaware Supreme Court, emphasized that creditors do not have the right to "assert direct claims for a breach of fiduciary duty against corporate directors", either when the company is in "the zone of insolvency" or when it is "actually insolvent". Accordingly, one cannot find in US law the concepts of "wrongful trading" or "deepening insolvency" (see *Trenwick Am Litig Trust v Ernst & Young, LLP*, 906 A.2d 168 (Del Ch 2006)).

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The business judgment rule protects directors from liability for errors of judgment. Pursuant to that rule, there is a presumption that the board of directors acted in good faith and based its actions on reasonable information. This is a presumption that can be rebutted only in three circumstances: by showing that the majority of the board did not have access to reasonable information; by showing that the board of directors didn't honestly believe in the utility of the decision taken for the entity's best interests; and by showing that they weren't acting in good faith. Apart from the rebuttal of the presumption, directors' liability can only be established by showing gross negligence. On another note, in accordance with section 102 of Delaware Corporation Law (Del Gen Corp L, §102(b)(7)), directors' liability in respect of the duty of care can be limited or eliminated within the content of a certificate of incorporation. Where approval of a certain transaction occurs by a majority of the board that has inherent interests and lacks independence, or by a shareholder who exercises control on both sides of the transaction, the business judgment rule will not apply. That particular transaction will be void absent satisfaction of the 'entire fairness standard'.

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#### Question 3.4 [5 marks]

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List and describe the requirements that a creditor's claim must fulfill in order to qualify as a petitioning creditor in an involuntary proceeding.

In order for a creditor to qualify as a petitioning creditor in an involuntary proceeding, certain specific elements regarding the creditor's claim should be observed.

The first element to examine is whether the claim is non-contingent. A non-contingent claim is one that is not subject to a future event. An unmatured debt is non-contingent in case of fulfilment of all other liability requirements except that the debt has not become due.

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The second element to explore refers to a claim not subject to a bona fide dispute concerning amount or liability. In the context of that element there are two concepts that need to be explained. The first concerns the nature of a bona fide dispute that depends on a reasonable basis established in an objective manner and involves questions of law or fact. In fact, subjective considerations of the debtor asserting

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incorrectness of the amount of the debt or that the debt is not owed, are insufficient. As to the second concept, in the event that part of the amount claimed is subject to dispute, the remaining part of the amount as undisputed cannot be aggregated to reach USD 16,750 for the unsecured or undersecured claims' requirement (see third element immediately below). It is nonetheless accepted that, notwithstanding the existence of a disputed claim of a creditor, undisputed claims held by the same creditor still allow the petitioning creditor's requirements to be met.

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The third and last element lies in the fact that the claim should be undersecured or unsecured reaching, individually or together with all other claims of petitioning creditors, as a minimum the amount of USD 16,750 (see 11 USC, §303(b)). Because of inflation, this amount is periodically adjusted.

In the context of an involuntary petition, an allegation is required that either the debtor fails generally to pay its debts as they become due, except if those debts are linked to a bona fide dispute regarding liability or amount, or that "[w]ithin 120 days before the filing of this petition, a custodian, other than a trustee, receiver, or an agent appointed or authorized to take charge of less than substantially all of the property of the debtor for the purpose of enforcing a lien against such property, was appointed or took possession" (Form B205 at 2).

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

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Question 4.1 [5 marks]

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**Speculation Inc is engaged in day-trading stocks from leased office space with two employees. It funds its trading through a margin loan from its broker, where the shares it purchases are held as collateral. For a while, Speculation Inc was very successful in trading, and the US Department of Justice (DOJ) has announced an investigation into whether its success was due to illegally trading on insider information. More recently, Speculation Inc has had serious trading losses, causing its broker to declare a default on the margin loan. It also has fallen behind on its rent, and been sued by a former employee alleging she was fired due to gender bias.**

**What would be the effect of a Chapter 11 petition being filed by Speculation Inc on each of the (i) DOJ investigation, (ii) margin loan default; (iii) delinquent lease and (iv) employment discrimination lawsuit?**

Upon the filing of a plenary petition the automatic stay applies. In respect of a Chapter 11 petition, the stay will give some breathing space to the debtor so that he will be able to, inter alia, negotiate with its creditors and structure a reorganization plan. The scope of the stay applies and extends to any interference with the debtor's property in any part of the world.

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In addition to specific indications regarding the application of the stay (11 USC, § 362(a)), section 362(b) sets forth certain exceptions. The Bankruptcy Code expressly exempts the act of conducting regulatory investigations from the application of the stay (see 11 USC, §362(b)(4)). In the case at hand, the investigation initiated by the US Department of Justice will not be stayed as an effect of the filing of a Chapter 11 petition. Despite the debtor's bankruptcy, the Bankruptcy Code acknowledges the existence of a greater public interest in the exercise of regulatory or police powers from government entities.

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Pursuant to section 362(b)(6), a Chapter 11 petition does not stay "[...] the exercise by a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency of any contractual right [...] under any security agreement or arrangement or other credit enhancement forming a part of or related to any commodity contract, forward contract or securities contract, or of any contractual right [...] to offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with 1 or more such contracts, including any master agreement for such contracts" (see 11 USC, §362(b)(6)). Speculation Inc. invests in its business utilizing a margin loan from a broker, for which the purchased shares are used as collateral. The broker declared default on the margin loan due to severe business losses of Speculation Inc.. Section 741 (11 USC) explicitly includes the margin loan in the category of securities contracts. A margin loan, in general, is used to invest in a business through a broker, who holds the purchased business shares as collateral. The US Bankruptcy Code thus provides the broker with the opportunity to pursue the appropriate remedies under the margin loan. More specifically, following the debtor-borrower's inability to meet margin call requirements, a default leads the lender to enforce its right to the repayment of the loan. That being said, the outcome of a petition for a reorganization proceeding will not entail the stay of any acts aimed at recovering the amount of the margin loan (e.g. such acts usually involve selling the debtor's assets or securities to repay the loan).

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In addition, pursuant to §362(a)(6), any attempt as regards the recovery of a pre-petition claim against the debtor is prohibited by the application of the stay. Demand letters or calls are thus also prohibited. According to the facts of the case, the tenant, Speculation Inc., is in arrears with the rent of the leased office space. In the context of the delinquent lease, therefore, the automatic stay upon a Chapter 11 petition will prevent any act to "collect, assess, or recover a claim against the debtor that arose before the commencement of the case" (11 USC, §362(a)(6)).

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Under section 362(a)(1), commencing or continuing an administrative, judicial or other proceeding or action against the debtor, that in fact was initiated or could have been initiated on a pre-petition basis, is a situation covered by the automatic stay. Commencing or continuing a judicial, administrative or other proceeding or action specifically intended to recover any pre-petition claim against the debtor is also prohibited by the stay. A former employee at Speculation Inc. filed an employment discrimination lawsuit, asserting that the dismissal was based on gender bias.

*Therefore, the effect of a Chapter 11 petition on the employment discrimination lawsuit will involve a stay of those proceedings.*

*It is though important to emphasize the purpose of the US Equal Employment Opportunity Commission (EEOC) which is responsible for enforcing federal laws on workplace discrimination. It covers employers with at least 15 employees (in the present case Speculation Inc. has two employees) and operates for a public purpose once it identifies violations of employees' rights and employment discrimination in all its forms. Nevertheless, any commencement or continuation of such an administrative proceeding by the employee before the EEOC is stayed by the Chapter 11 petition. Interestingly, the automatic stay cannot apply if the EEOC itself, after investigation, commences an action against the debtor for a public purpose (see 11 USC, §362(b)(4), "to enforce such governmental unit's or organization's police and regulatory power"). In the case at hand, other than the fact that Speculation Inc. has two employees, we cannot determine any relevant elements that could establish a public purpose for the EEOC to undertake such an action. The employee filed an individual lawsuit and, as previously mentioned, a stay of those proceedings applies. It may also be possible for the employee to seek a modification of the stay from the court to allow the proceeding to be completed. The bankruptcy court considers very specific factors when assessing the need to modify the stay in this context.*

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**Question 4.2** [5 marks]

***Stella SA (Stella) is an international cosmetics company incorporated in France, with its headquarters in Paris. Stella's products are made in Italy and shipped to its retail stores in Europe (including England), Asia, and North America. Stella's funding comes from a bank loan and Eurobonds, both of which are governed by English law. Stella's retail sales have suffered due to pandemic-related closures and it is considering options to restructure its debt. One option is to use an English scheme of arrangement with respect to the Eurobonds. Could the English scheme of arrangement be recognized by a US bankruptcy court under Chapter 15, and would such recognition be as a foreign main or non-main proceeding?***

*English schemes of arrangement have been an attractive solution for distressed companies around the globe. Over the years, English courts have seen an increase in companies from overseas opting for schemes of arrangement governed by English law.*

*The streamlined procedure established under Chapter 15 proceedings in the US Code comprises the filing of a petition with primary scope the recognition of a foreign proceeding on US territory. As there is no creation of any insolvency estate, the proceeding is considered ancillary by US law. An automatic stay is granted only upon recognition of a foreign main proceeding and, generally speaking, regardless of whether the stay is interim, automatic or discretionary, it only refers to assets within the US jurisdiction. An interim stay or other assistance may be granted by the Bankruptcy Court for the period between the filing of the petition and the recognition decision.*

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Post-recognition stay or other assistance are also available. Pre-recognition and post-recognition relief may also be granted for a foreign non-main proceeding. The foreign representative is the crucial factor in terms of filing the Chapter 15 petition and monitoring the administration of the debtor's assets on US territory after recognition.

The requirements set forth in Section 1515 of the US Bankruptcy Code include the establishment by the foreign representative of the existence of a foreign proceeding that is pending and that the foreign representative is authorized to act. Chapter 15 proceedings may not be initiated where they relate to particular persons that are exempted from Chapter 7 or are included in Chapter 13 or even concern "an entity subject to a proceeding under the Securities Investor Protection Act of 1970, a stockbroker subject to subchapter III of chapter 7 of this title, or a commodity broker subject to subchapter IV of chapter 7 of this title" (11 USC, §1501(c)). Most important, for the recognition of a foreign proceeding there is no need that the proceeding itself resembles a US bankruptcy. In section 101(23), a foreign proceeding is defined as "collective judicial or administrative proceeding in a foreign country, including an interim proceeding, under a law relating to insolvency or adjustment of debt in which proceeding the assets and affairs of the debtor are subject to control or supervision by a foreign court, for the purpose of reorganization or liquidation". In accordance with this definition, foreign proceedings have been recognized in the US notwithstanding their diverse and unique characteristics. English schemes of arrangement, creditor-appointed receivers under Australian law or "recuperação judicial receivers" under Brazilian law constitute notable examples. Even if the proceeding under scrutiny meets the requirements of a foreign proceeding, such a proceeding may nevertheless be refused recognition for being 'manifestly contrary to public policy' (see 11 USC, §1506). However, it should be noted that the public policy concept under Chapter 15 is narrowly construed. It is less applicable to the matter of recognition than to the issue of granting additional assistance. Besides, it is accepted that differentiations in insolvency schemes do not in themselves automatically trigger the application of Article 6 (see 'UNCITRAL Model Law on Cross-Border Insolvency with Guide to Enactment and Interpretation', para. 30).

Schemes of arrangement are linked to the question of whether they form part of 'a law relating to insolvency'. Several common law jurisdictions have recognized such proceedings (e.g. *Syncreon Group B.V.*, 2019 ONSC 5774 (Canada); see 'Digest of Case Law on the UNCITRAL Model Law on Cross-Border Insolvency', para. 11, Article 2). US courts also recognized schemes of arrangement originating from South Africa (*In re Cell C Proprietary Ltd*, 542 B.R. 571 (Bankr. S.D.N.Y. 2017)) and the United Kingdom (*In re Avanti Commun'c Group PLC*, 582 B.R. 603, 613 (Bankr. S.D.N.Y. 2018)). The Judicial Perspective (see 'UNCITRAL Model Law on Cross-Border Insolvency: The Judicial Perspective (Updated 2022)', footnote 125) notes that the addition of the words "or adjustment of debt" to the definition might influence to a certain extent the recognition of a scheme of arrangement.

In our example, an international company, Stella SA, is headquartered in Paris, France. While the company's products are manufactured in Italy, these products are shipped

to Europe, Asia and North America to the respective retail stores. The company also operates a retail store in England. Stella's funding is based on Eurobonds and a bank loan. Due to economic constraints, the company is planning to restructure its debt using an English scheme of arrangement in terms of the Eurobonds.

An ancillary Chapter 15 proceeding can be initiated following the straightforward requirements set out in the Bankruptcy Code. The proceeding will concern assets situated in the US territory. The above-mentioned exceptions as to the persons that may not commence such proceedings do not apply in the present case. An assessment of recent US case law gives a positive answer to the question of whether recognition of English schemes of arrangement is possible. US Courts have been recognizing various proceedings originating from different legal traditions and have been interpreting those proceedings as insolvency law-related in the context of Chapter 15. Even the concept of public policy is given narrow interpretation by US Courts and such discussions are mostly present in the field of additional assistance.

Turning to the issue of the recognition of a foreign main or non-main proceeding, it is important to underscore the legal challenges surrounding these discussions. The determination of the proceeding as foreign main or non-main is crucial for the type of the subsequent relief that will be granted. If a proceeding has been initiated in the center of main interests of the debtor (COMI) then it concerns a foreign main proceeding. In case the proceeding took place in a different jurisdiction than the COMI of the debtor then the proceeding could be determined as a foreign non-main proceeding. Nevertheless, this is possible only in the event the debtor has an establishment in that jurisdiction. An establishment, simply put, refers to a place of operations where the debtor performs "non-transitory economic activity". Both concepts, COMI and establishment, have been imported from European insolvency law into US Chapter 15 proceedings.

For the determination of jurisdiction, instead of the concept of COMI, US law utilizes concepts such as principal place of business, domicile and location of assets of the debtor (see *Morning Mist Holdings Ltd v Krys (In re Fairfield Sentry Ltd)*, 714 F.3d 127, 133-34 (2d Cir 2013)). Concerning Chapter 15 proceedings, the debtor's COMI is presumed to be the debtor's place of incorporation. However, pursuant to section 1516(c) of the US Bankruptcy Code, this is a rebuttable presumption. Important factors that are taken into account by the court during the COMI analysis involve the location of the debtor's headquarters, the location of its management, the location of its primary assets, the location of the majority of creditors "or at least those affected by the case" and the applicable law that will be applied in most disputes (*Morning Mist* at [137], citing *In re SphinX Ltd*, 351 B.R. 103, 117 (Bankr. S.D.N.Y. 2006)). Moreover, the *Morning Mist Holdings Ltd v Krys* case also added the element of 'ascertainability' of the debtor's COMI with respect to its creditors or third parties subject to objective evidence. In fact, according to the analysis of the Guide to Enactment and Interpretation of the Model Law on Cross-Border Insolvency, a significant factor is the location of the debtor's central administration which should be "readily ascertainable by creditors" (see 'UNCITRAL Model Law on Cross-Border Insolvency with Guide to

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*Enactment and Interpretation', para. 145). For consistency purposes, this analysis should consider the date of commencement of the foreign proceeding.*

*The concept of 'establishment' is primarily based on specific evidence. It must be shown that the debtor "carries out a non-transitory economic activity" in the relevant State. Indeed, as the *Judicial Perspective* notes (see *UNCITRAL Model Law on Cross-Border Insolvency: The Judicial Perspective (Updated 2022)*', para. 143), since there is no presumption for this concept, the existence of an establishment is a question of fact. Several cases have given significant guidance on the notion of establishment. For instance, in the *Bear Stearns* case (*Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd (In re)* 389 B.R. 325 (S.D.N.Y. 2008)), the US Bankruptcy Court linked the term 'establishment' with 'a local place of business'.*

*In the case at hand, if Stella SA decides to restructure its debt via an English scheme of arrangement for the Eurobonds then the court from which the foreign proceeding would arise would be the court of the United Kingdom. As previously analyzed, the US Bankruptcy Courts have a long tradition in the recognition of English schemes of arrangement. A challenging point, however, relates to the assessment of Stella's COMI. From the facts of the case, it is accepted that Stella SA has its headquarters in Paris and that there is a connection to the UK jurisdiction via its retail store in England. It is evident that, for the COMI test to be successful, the headquarters, the management, the primary assets, the majority of creditors and the law applicable to the majority of disputes should be linked to the United Kingdom, something that does not occur in this case. With its headquarters in Paris, and presumably management activities ('nerve center') also carried out there, Stella SA cannot be considered having its COMI in the UK. A more consistent and flexible reasoning would be to consider the UK as a jurisdiction where Stella SA has an establishment. For that purpose, since the company operates a retail store, and, therefore, a 'local place of business', in England, the best solution would be for the US Bankruptcy Court to recognize the English scheme of arrangement as a foreign non-main proceeding.*

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**Question 4.3 [5 marks]**

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**ToyCo is an American toy company that has created a popular line of folding robot toys called Xblox. The toys are covered by several US patents. Currently, GameMart Inc (GameMart) has a 10-year exclusive license to manufacture Xblox and pays ToyCo monthly royalties. GameMart operates a factory in California that it leases from Land Corp on a longer term lease with seven years to go; the lease prohibits assignment without Land Corp's consent. The Xblox toys are selling well, but GameMart's other toy lines are doing poorly, so it is considering a Chapter 11 bankruptcy. Answer the following questions:**

- (i) **Is the license to manufacture Xblox an executory contract?**

*In accordance with section 365 of the US Bankruptcy Code, there is the possibility to reject, assume or assume and assign an executory contract. Case law has shaped and developed the meaning of executory contracts. What makes a contract executory is the existence of material obligations that have not been performed by both parties. In the context of a Chapter 11 case, the debtor can use the possibility provided by section 365 and has to decide on the future of those contracts until the confirmation of the reorganization plan. The bankruptcy court may impose a deadline, however, upon a counterparty's request for cause. The decision to reject or assume a contract should be made in accordance with the business judgment of the debtor-in-possession or trustee with the purpose of facilitating the reorganization of the entity. The court may refuse to approve the decision in cases of lack of good faith or reasonable exercise of the debtor's or trustee's business judgment.*

*An important consideration relates to the fact that contractual restrictions regarding the assignment of contracts are eliminated in order to increase the value of the debtor's assets. More specifically, the requirement of counterparty consent can be found in contracts relating to financial accommodations and loans. It can also be found in situations where non-bankruptcy law states that the counterparty cannot be obligated to accept performance on behalf of a transferee (11 USC, §365(c)). This has been interpreted as covering both the situations of assumption and assignment. Certain courts in assessing the substance of this prohibition have applied the 'hypothetical test' (the Third, Fourth, Ninth, and Eleventh Circuits) which implies that the assumption of an executory contract that is not permitted to be assigned should not be possible. Other courts (the First and Fifth Circuits, and lower courts in the Seventh, Eighth, and Tenth Circuits) have concluded, developing the 'actual test', that the prohibition should apply only when the debtor is planning to assign the contract.*

*A US company, ToyCo, has designed a very successful line of toys ('Xblox toys') which are covered by a number of US patents. GameMart is a company that has a 10-year exclusive license in the production of Xblox toys and pays ToyCo the respective royalties every month.*

*In a Chapter 11 proceeding, the license agreement would be characterized as an executory contract. ToyCo, on the one hand, is allowing GameMart to manufacture Xblox toys through a 10-year exclusive license and GameMart, on the other hand, is paying ToyCo monthly royalties. Both parties have unperformed obligations under the license agreement. Nevertheless, the latter would not be assignable as, according to intellectual property licensing law, the counterparty must give its consent for this to happen.*

**(ii) Can GameMart transfer the Xblox license as part of 363 sale without ToyCo's consent? Why or why not?**

*In the context of a Chapter 11 proceeding, it is possible for the property of the debtor to be sold free and clear of creditors' interests following court approval. The procedure*

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is known as a '363 sale'. As explained in the previous question, the debtor is allowed to assume, reject or assume and assign a license agreement under section 365. The interpretation of section 365 provisions varies among courts. Thus, it is possible for the debtor-licensee to 'assume and assign' its licensing rights to a third party. It is equally possible for the purchaser of intellectual property assets to oblige the debtor-licensor to reject or to assume and assign any eventual licenses linked to those assets. A 363 sale, therefore, involves the assumption and assignment of the IP license in accordance with Section 365. Pursuant to subsections 365(b)(1) and (f), assumption and assignment require the debtor to cure any defaults and the assignee to give appropriate assurances as to the licence's future performance. Notwithstanding subsection 365(f) that authorizes the assignment by a debtor even where such assignment is prohibited contractually or by applicable law, subsection 365(c) elaborates on the existing restrictions in the assumption and assignment of IP licenses if the counterparty does not consent. It is also important to note that there are several elements involved in making an IP license appropriate to be assumed and assigned, such as the court, the characteristics of the license agreement, the type of the intellectual property and so on.

In the present case, GameMart has an exclusive license to produce Xbox toys. In case GameMart enters Chapter 11 proceedings and decides to assume and assign the license agreement then, pursuant to subsection 365(c), the transfer of the Xbox license in a '363 sale' requires the counterparty's (ToyCo as the licensor) consent. This is due to the protections afforded by the US Bankruptcy Code to license agreements and IP rights in general as part of non-bankruptcy law (IP licensing law).

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**(iii) Can GameMart transfer the factory lease as part of 363 sale without Land Corp's consent? Why or why not?**

In order to answer the question, first of all, it would be appropriate to examine whether the contract is considered executory. An executory contract, as already mentioned in question 4.1 above, refers to a contract with unperformed obligations on behalf of the two counterparties. Secondly, it is important to enquire whether the lease agreement may be assignable without counterparty consent. Through a 363 sale, the debtor is able to transfer its interests in contracts, especially when particular contracts are essential for the continuation of its business operation. Interestingly, section 365(c) eliminates restrictions on assignment present, for instance, either contractually or in ipso facto clauses intended to terminate a contract upon the filing of a bankruptcy petition.

GameMart operates a factory in California that is subject to a long term lease. The lease contract between GameMart and Land Corp is executory by virtue of the parties' contractual rights and obligations under the agreement. The lease agreement explicitly prohibits assignment without the lessor's (Land Corp) consent. However, pursuant to subsection 365(c), this restriction is statutorily eliminated. GameMart is authorized to pursue a 363 sale without Land Corp's consent.

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**\* End of Assessment \***