



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).***
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- 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^[la1]

QUESTION 1^[la2](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^[la3]

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^[la4]

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^[1a5]

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^[1a6]

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^[1a7]

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^[1a8]

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^[1a9]

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^[1a10]

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^[1a11]

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^[1a12]

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 [1a13] (direct questions) [10 marks]

Question 2.1 [1a14] (1 mark)

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

Setoff permits a creditor holding a claim against the debtor and simultaneously owing money to the debtor to net out the two (or more) obligations. [1a15] Because setoff rights can improve the position of the creditor as compared to other unsecured creditors who are not owed money by the debtor because it decreases its obligation to the estate by the full amount owed by the debtor rather than the lesser amount the debtor would pay on the unsecured claim, setoff is not permitted in a number of circumstances [1a16]:

- *the creditor's claim against the estate is disallowed;*
- *the creditor's claim against the estate was acquired post-petition or in the 90 days prior to the petition at a time when the debtor was insolvent: 179*
- *the creditor's obligation to the debtor was incurred in the 90 days prior to the petition at a time when the debtor was insolvent for the purposes of exercising setoff rights;*
- *the creditor improves its position by setoff as compared to its position had setoff been exercised 90 days prior to the petition.*

A number of transactions are, however, exempted from these restrictions on setoff, most importantly commodity, forward, security, repurchase, swap, and master netting contracts.

Question 2.2 [1a17] [2 marks]

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

The debtor must file [1a18], together with a voluntary petition or on a date specified by the court, a number of schedules disclosing its assets, including all property, executory contracts, and unexpired leases of real and personal property, and its liabilities, including identifying its secured and 20 largest unsecured claims. These schedules are electronically filed on the docket of the proceedings and therefore are publicly available. The social security numbers of individual persons and names of minors must be redacted, but other redactions or filing under seal are granted only by leave of court and subject to limitations due to the presumption that the public should be permitted to access information about pending legal proceedings. Debtors preparing for a voluntary filing should consider whether such disclosures may violate contractual or other confidentiality obligations, including under foreign data privacy law, and confer with the US Trustee about appropriate measures. The US Trustee will strongly oppose any sealing request that would prevent it from soliciting creditors to constitute the Committee of Unsecured Creditors.

Question 2.3^[1a19] [2 marks]

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

The absolute priority rule requires that payment in full must be made to each category of claims before the next category receives anything.^[1a20] *In a chapter 11 plan,*^[1a21] *deviation from the absolute priority rule is permitted with the consent of affected creditors*^[1a22], *but deviation is not permitted in chapter 7, where the statutory priorities must be strictly followed.*

Question 2.4^[1a23] [2 marks]

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

If financing cannot be obtained on any other terms^[1a24], *the court may grant a priming lien that is senior or equal to a pre-petition lien on estate property to secure post-petition financing.*^[1a25]

The debtor also must demonstrate that the interest of the secured creditor being primed is adequately protected^[1a26].

These ‘other terms’ includes:

(a) The debtor in possession can incur unsecured debt or obtain unsecured credit (for example, from suppliers) in the ordinary course of business without court approval, with the debt being granted administrative priority expense (whereas, had it been incurred pre-petition, it would be only a general unsecured claim).

(b) The debtor in possession can incur unsecured debt or obtain unsecured credit outside the ordinary course of business with court approval after notice and a hearing, with the debt again having administrative expense priority.

(c) Upon a showing that the debtor has been unable to secure sufficient funding under (a) or (b), the court can authorize one of the following, after notice and a hearing:

(1) unsecured debt having priority ahead of all other administrative expenses;

(2) secured debt with a lien on unencumbered estate property;

(3) secured debt with a junior lien on encumbered estate property.

Question 2.5^[1a27] [3 marks]

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?

A preference is a transfer of the debtor's property made in a suspect period before the petition date that must be returned to the estate if it exceeds the amount the recipient would have received in a chapter 7 liquidation had the transfer not been made.

Importantly, there is no need to show any fault of either the debtor or the recipient in connection with the payment having been made, and the recipient creditor suffers no penalty other than return of the transfer (and, potentially, prejudgment interest from the date of the transfer).

The elements of a preference claim are:

- (1) A transfer of an interest of the debtor in property. The transfer may be of funds, property or an interest in property - that is, the granting of a lien. Transfer of property in which the debtor does not have an interest, such as property held as agent for another, cannot be a preference.**
- (2) To or for the benefit of a creditor. If the recipient was not a creditor of the debtor prior to the transfer, the transfer cannot be a preference, but may be recoverable as a fraudulent conveyance.**
- (3) For or on account of an antecedent debt owed by the debtor before such transfer was made.**

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?

Because district courts have exclusive jurisdiction to adjudicate a petition commencing bankruptcy proceedings, a bankruptcy court may exercise a district court's delegated authority to enter a final order on a motion challenging the validity of a petition. The US Supreme Court has held that bankruptcy judges 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 as in noncore proceedings, or, with the consent of the parties, may issue final orders. The Bankruptcy Rules have implemented these rulings by requiring litigants to state in their pleadings whether they consent to the entry of final orders or judgment by the bankruptcy court, and by permitting a district court that determines that a bankruptcy court did not have jurisdiction to enter a final order to treat that its order as proposed findings of fact and conclusions of law.

If the ruling below was in a core proceeding over which the bankruptcy court had authority (whether by law or by consent of the parties) to enter a final order, the district court or BAP reviews conclusions of law de novo and reviews findings of fact for abuse of discretion, recognizing that the bankruptcy court had greater opportunity to weigh the evidence. If the ruling was in a noncore proceeding or the bankruptcy court otherwise did not have authority to enter a final order, the district court or BAP

reviews de novo all findings of fact and conclusions of law to which a party has objected. The order of a district court or BAP is reviewed by a circuit court of appeal de novo as to conclusions of law and for abuse of discretion for findings of fact.

Question 3.2 [1a40] [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?

- **Automatic stay** [1a41]
- **operation of the debtor's business in the ordinary course by the foreign representative** [1a42];
- **sale, transfer or use of property outside the ordinary course** [1a43];
- **avoidance of post-petition transfers and post-petition perfection of security interests.**

Upon recognition of a foreign non-main proceeding, any of the above relief may be granted on a discretionary basis. In addition, following recognition as either foreign main or foreign non-main, the following relief also may be granted on a discretionary basis:

- (1) **authorization of discovery regarding the debtor's assets and affairs** [1a44];
- (2) **entrusting administration of the debtor's US assets to the foreign representative or other person** [1a45];
- (3) **extension of provisional relief** [1a46];
- (4) **any other relief "necessary to effectuate the purposes of [chapter 15] and to protect the assets of the debtor or the interests of creditors."**

Question 3.3 [1a47] [4 marks]

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?

Directors' duties are owed to the corporation and its shareholders, not to creditors, even in circumstances where the corporation is potentially insolvent [1a48] and therefore the shareholders stand to receive nothing in bankruptcy. The Delaware Supreme Court has put to rest any suggestion that directors owe duties to creditors when a company is operating "in the zone of insolvency, or indeed is actually insolvent.

*Directors owe a fiduciary duty of **loyalty** [1a49] to the corporation's best interest and a duty of **care** [1a50] in educated decision-making, but are protected from liability for errors*

of judgment by the **business judgment rule**.^[1a51] Under the business judgment rule, the board of directors is presumed to have acted in good faith on the basis of reasonable information. This presumption can be rebutted only by showing that a majority of the board in fact were not reasonably informed, did not honestly believe that their decision was in the corporation's best interest, or were not acting in good faith. Unless the presumption is rebutted, the directors will not be liable in the absence of a showing of gross negligence. In addition, directors may be exculpated by a corporation's certificate of incorporation from liability for breach of the duty of care (but not for breach of the duty of loyalty). The business judgment rule does not apply where a transaction is approved by a board majority that is not disinterested and independent or a controlling shareholder is on both sides of the transaction. In such circumstances, the transaction will be void unless the entire fairness standard is satisfied.

Question 3.4^[1a52] [5 marks]

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

To qualify as a petitioning creditor, the creditor must have a claim against the debtor that is:

- **Non-contingent**^[1a53]

A contingent claim is one that depends on the occurrence of a future event^[1a54]. For example, a claim under a guarantee is typically contingent on the occurrence of a default under the guaranteed obligation.

- A debt that is unmatured (because the payment is due in the future) is not contingent if all requirements for liability, other than the passage of time, have occurred.
- **Not the subject of bona fide dispute as to liability or amount**^[1a55]

A bona fide dispute exists if there is an objectively reasonable basis for a dispute as a matter of fact or law;^[1a56] the debtor's subjective belief that the debt is not owed or the amount claimed is incorrect is not sufficient.

- If a portion of the amount claimed is disputed, the creditor cannot use the undisputed portion to reach the monetary threshold required in the next bullet, but a dispute as to one claim does not disqualify application of other, undisputed claims held by the same creditor to meet petitioning creditor requirements.
- **Unsecured or undersecured**^[1a57], separately or in the aggregate with all other petitioning creditors' claims, in the amount of at least **USD 16,750**^[1a58] (this amount is periodically increased due to inflation)

QUESTION 4 [1a59] (fact-based application-type question) [15 marks in total]

Question 4.1 [1a60] [5 marks]

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 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?

An automatic stay will apply upon filing of a Chapter 11 petition. [1a61] The scope of the automatic is extremely broad - it applies to any interference with the property of the estate anywhere in the world, subject to some statutory exceptions.

(i) DOJ investigation: will continue as the automatic stay is subject to some statutory exceptions, and regulatory investigations are one of them [1a62].

(ii) margin loan default [1a63]: any attempt to collect on pre-petition claims (including through demand letters or calls) will be prohibited by the stay, including claims regarding the margin loan default.

(iii) delinquent lease: the automatic stay is subject to exceptions of eviction of a debtor-tenant from non-residential property where the lease has expired. Therefore, Speculation Inc might be evicted from its offices [1a64].

(iv) employment discrimination lawsuit: any litigation on pre-petition claims will be prohibited as a consequence of the automatic stay [1a65].

Question 4.2 [1a66] [5 marks]

Stella SA (Stella) is a 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?

Foreign proceedings need not resemble a US bankruptcy case to be recognized. A foreign proceeding is defined by the Bankruptcy Code as "a collective judicial or administrative proceeding in a foreign country 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." Under this definition, English schemes of arrangement can be recognised.

Foreign main proceedings are those that are commenced in the debtor's center of main interests (COMI). A debtor's COMI is presumed to be its place of incorporation, but this is rebuttable. Relevant factors in the COMI analysis include:

- *location of headquarters;*
- *location of management;*
- *location of primary assets*
- *location of a majority of debtor's creditors or a majority of the creditors that will be affected by the relief requested by the foreign representative; and*
- *jurisdiction whose law will apply to most disputes.*

In Stella's case, COMI is presumed to be in its place of incorporation^[1a67], France. Other relevant factors includes:

- *headquarters in Paris*
- *location of primary assets: products are made in Italy, retail stores in Europe (including England), Asia, and North America*
- *location of creditors: likely to be in Europe (who invest in Eurobonds)*
- *jurisdiction whose law will apply to most disputes: The Eurobonds are governed by English law*

Therefore, it is possible that England can be considered as COMI therefore being the foreign main proceedings. Otherwise it will be a non-main proceeding^[1a68].

Question 4.3^[1a69] [5 marks]

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 Xbox an executory contract?

Yes. As there are material non-performed obligations on both sides under the contract - GameMart needs to pay monthly royalties, and ToyCo needs to provide it licence^[1a70].

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

Counterparty consent is only required where the contract is one to make a loan or other financial accommodation, or where substantive non-bankruptcy law (such as intellectual property licensing law) provides that the counterparty cannot be compelled to accept performance from a transferee.^[1a71] **Because the prohibition is phrased as prohibiting either assumption or assignment, some courts have concluded that a debtor may not assume an executory contract that it would not be permitted to assign (the hypothetical test). Thus, for example, a licensee of a third-party's intellectual property might not be able to assume and continue performing under a pre-petition license without the licensor's consent. Other courts have held that this provision applies only where the debtor actually intends to assign the agreement (the actual test).**

Under the hypothetical test, GameMart cannot assign without consent of ToyCo, but under the actual test, it can assign the contract^[1a72].

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

Because the terms of the lease prohibit assignment without Land Corp's consent, it cannot be transferred without Land Corp's consent.^[1a73]

*** End of Assessment ***