

**American Board of Certification
General Bankruptcy Law
Multiple Choice Sample Questions**

NOTE: The Bankruptcy Multiple-Choice exam contains 50 questions. You must correctly answer 60%, or get at least 30 correct. We offer 16 sample questions here to give you an idea of the scope of the questions you are likely to encounter, as well as the types of subject matter covered.

1. During the pendency of the case and without obtaining an order lifting or modifying the automatic stay, the child support claimant may not take the following action:
- a. levy upon Don's exempt property.
 - b. garnish the wages Don will earn next week.
 - c. commence an action in state court to increase the amount of child support.
 - d. levy on property of the estate.

D is correct. A levy on exempt property is allowed under § 522(c)(1). B and C (garnishment of postpetition wages and modification of child support actions) are allowed under § 362(b)(2).

2. Don Debtor's principal residence, worth \$120,000, is subject to two encumbrances: (1) a first mortgage for \$100,000; and (2) a judicial lien in favor of Credit Card Inc. for \$60,000 that is junior to the mortgage in priority. Assume that under the relevant state's law, Don is entitled to claim a \$30,000 homestead exemption in the home. If Don files a petition under Chapter 7 and brings a lien avoidance action under §522(f), how much, if any, of the lien can be avoided?
- a. \$0, because the lien is not avoidable in any amount.
 - b. \$40,000, because that is the amount by which the sum of the mortgage and the lien exceeds the value of the residence.
 - c. \$30,000, because the lien is avoidable only to the extent of the exemption.
 - d. \$50,000, because the sum of the first mortgage and the exemption exceed the value of the home.

D. is correct. Section 522(f)(2)(A) calculates impairment by adding the challenged judicial lien, all other liens, and the exemption, and then subtracting the value of the debtor's interest from that sum. The remainder is the amount that may be avoided. In this case, the \$60,000 judicial lien, the \$100,000 mortgage and the \$30,000 exemption = \$190,000, which exceeds by \$70,000 the value of the home. Because this sum is greater than the amount of the judicial lien, the whole lien may be avoided.

3. In a Chapter 7 case, in order for a non-tax claim of a governmental unit to be timely, when must it be filed?

- a. within 90 days after the date of the order for relief
- b. within 90 days after the first date set for the §341 meeting of creditors
- c. within 180 days after the date of the order for relief
- d. within 180 days after the first date set for the §341 meeting of creditors

C is correct under Bankruptcy Rule 3002(c)(1), which treats all government claims as timely if filed within 180 days of the order for relief. Other claims must be filed within 90 days after the first date set for the meeting of creditors.

4. Prior to filing bankruptcy, the electric utility was threatening to discontinue service because the debtor owed \$1,000 in past-due charges for electrical service. If the debtor furnishes adequate assurance of payment for post-petition service, then:

- a. the electric utility can discontinue electrical service because of the unpaid pre-petition charges
- b. the debtor can continue to receive electrical service without paying the pre-petition charges
- c. the debtor can continue to receive electrical service only by paying \$1,000 for the pre-petition service
- d. the debtor can continue to receive electrical service only by promptly curing the pre-petition default and assuming the service contract under § 365

B is correct. See § 366(b).

5. Donna Debtor filed a voluntary petition under Chapter 7 on February 1. Almost two years earlier, Donna was libeled by Larry Lie. Under the relevant state statute of limitations, Donna had until April 1 to file a legal action against Larry. Tom Trustee was appointed as trustee in Donna's Chapter 7 case on March 1. The time within which Tom Trustee may commence a legal action against Larry on behalf of the estate expires:

- a. on April 1
- b. sixty days after February 1
- c. two years after February 1
- d. two years after March 1

C is correct. See § 108(a).

6. On Monday, June 1, the Bankruptcy Court announced its decision in a core proceeding from the bench. On Friday, June 5, a judgment was entered consistent with the decision announced from the bench. Absent an extension, if you wish to appeal the Bankruptcy Court's decision, your notice of appeal must be filed:

- a. within ten calendar days of June 1
- b. within ten calendar days of June 5
- c. within twelve calendar days of June 1, because the intervening Saturday and Sunday are excluded from the computation
- d. within twelve calendar days of June 5, because the intervening Saturday and Sunday are excluded from the computation

B is correct. See Fed. R. Bankr. P. 8002(a), Fed. R. Bankr. P. 9006(a).

7. This morning Donna Debtor filed bankruptcy. She owes Big Bank \$3,000 on an unsecured loan and has \$2,000 on deposit in her checking account. Under the relevant state law, Big Bank has a right to set off the checking account balance against the loan debt, but had not yet done so when the bankruptcy filing was made. Which of the following is most likely correct?

- a. Big Bank may place an administrative “freeze” on the account without obtaining court permission to do so
- b. Big Bank must turn over the account to the chapter 7 trustee
- c. Big Bank may set off the account against the loan debt without obtaining court permission to do so
- d. Big Bank no longer has a right of setoff, because the Bankruptcy Code does not respect state rights of set off

A is correct. See Citizens Bank v. Strumpf, 516 U.S. 16 (1995). B is incorrect because of § 542(b). C is incorrect because of § 362(a)(7). D is incorrect under § 553(a).

8. Which of the following statements about bankruptcy discharges is the most accurate?

- a. In a chapter 7, the debts are discharged 60 days following the first date set for the meeting of creditors.
- b. In a chapter 11, the confirmation of a plan discharges the debtor from any debt that arose before the date of confirmation
- c. In a chapter 13, the confirmation of a plan discharges the debtor from any prepetition debt, but not any debt arising after the filing
- d. A “superdischarge” under chapter 13 may be granted even if the distributions made pursuant to the plan are less than the unsecured creditors would have received if the debtor had been liquidated in a chapter 7

B is correct. A is incorrect under § 727 (although objections to discharge must be filed within 60 days following the first date set for the meeting of creditors under Fed. R. Bankr. P. 4004(a). C and D are incorrect under § 1328.

9. Howard has been a little lax in his payment of income taxes. In fact, he has not filed a return since 2003. Assuming he files for Chapter 7 bankruptcy in May, 2009, how will his tax liabilities be handled in the case?

- a. his tax liabilities for each of the years for which he did not file a tax return will be priority claims

- b. a proof of claim filed by the government will be timely only if it is filed not later than 90 days after the first date set for the meeting of creditors
- c. his tax liabilities for 2006 – 2008 will not be discharged even if no claim is filed by the government
- d. an action may be brought in the United States Tax Court to determine Howard's tax liability for any prepetition period without violating the automatic stay

C is correct under § 523(a)(1). A is incorrect under § 507(a)(8) because only the 2006-2008 tax liabilities would be priority claims. B is incorrect under Fed. R. Bankr. P. 3002(c)(1), which gives the government 180 days after the date of the order for relief, subject to extension. D is incorrect under § 362(a)(8).

10. Debtor Inc. is in deep financial trouble. It has dozens of creditors and it has stopped paying its monthly bills. Among its creditors are three suppliers, Supplier A, Supplier B, and Supplier C. Each is owed \$2,000 in unsecured trade debt. Debtor Inc. also owes \$12,000 to Electric Co. for past due electrical bills. Another creditor is Contractor Inc., which asserts a \$12,000 unsecured breach of contract claim. Debtor Inc. disputes the Contractor Inc. claim and asserts, in good faith, that Contractor Inc. committed a material breach of the contract and is entitled to no payment whatsoever. Debtor Inc.'s only secured creditor is Finance Co. Finance Co. is owed \$15,000 and holds a perfected security interest in Debtor Inc.'s delivery truck, which has a value of \$6,000. Assume that the bankruptcy court will order relief against Debtor, Inc. if a proper involuntary petition is filed under §303 of the Bankruptcy Code. The petition will be successful if:

- a. Supplier A, Supplier B, and Finance Co. join in the petition.
- b. Supplier A, Supplier B, and Contractor Inc. join in the petition.
- c. Supplier A, Supplier B, and Electric Co. join in the petition.
- d. Electric Co., alone, files the petition.

C is correct. Under § 303, if there are more than 12 unsecured creditors holding claims not contingent as to liability or the subject of a bona fide dispute as to liability or amount, three or more such creditors holding claims aggregating at least \$13,475 may file an involuntary petition. The

claimants in A have only \$13,000 of unsecured debt. (Finance Co. has a \$6,000 secured claim and a \$9,000 unsecured claim under § 506). The claimants in B include Contractor, whose claim is disputed. D does not include three creditors.

11. In a divorce decree entered in a divorce action in a state court of record, Don Debtor was ordered to pay \$500 per month in child support to his ex-wife for the support of the minor children of the marriage. Don was \$1,000 in arrears on the child support payments at the time he filed Chapter 7. Which of the following statements is the most accurate?

- a. The automatic stay will prevent the collection of the \$1,000 arrearage from Don's future wages.
- b. The automatic stay will prevent the collection of future support payments from the property of Don's Chapter 7 estate.
- c. The automatic stay will prevent the collection of future support payments from Don's future wages.
- d. Don may be discharged from his past-due child support payments in the bankruptcy case.

B is correct because §362(b)(2) exempts from the stay the collection of support from property that is not property of the estate. Thus, regardless of whether the support obligation accrued pre-petition, only collection against property of the estate is stayed. Since Don's future wages will not be property of his Chapter 7 estate, A & C are incorrect. D is incorrect under § 523(a)(5).

12. May a plan of reorganization in a chapter 11 be confirmed if it violates the best interest of creditors test under §1129(a)(7)?

- a. Yes, so long as each class of creditors approves the plan by a vote of more than one-half in number and at least two-thirds in amount
- b. Yes, but only in a cramdown plan
- c. Yes, as long as no holder of an impaired claim has objected to confirmation of the plan on this ground
- d. No

C is correct because the protection of §1129(a)(7) applies only to an impaired claimant who objects to the plan. A class vote cannot affect the individual creditor's rights, so A is incorrect. A cramdown plan under § 1129(b) must satisfy § 1129(a)(7), so B is incorrect. D is incorrect because the court may confirm the plan if no objection is made.

13. Assume that an undersecured creditor makes the §1111(b) election in a Chapter 11 case. Which of the following statements is not accurate?

- a. The creditor must receive payments under the plan at least equal to the amount of its allowed claim.
- b. The creditor must receive payments under the plan having a present value at least equal to the value of the collateral securing its claim.
- c. The creditor loses its unsecured deficiency claim.
- d. The creditor must receive or retain under the plan on account of its claim property of a value, as of the effective date of the plan, that is not less than the amount that such creditors would so receive or retain if the debtor were liquidated under chapter 7 on such date.

D is the best answer, because it is the incorrect statement. A and B are correct under the language of the §1129(b)(2)(A)(i)(II). C is correct under §1111(b)(2). D is incorrect because under § 1129(a)(7)(B), the holder of a claim held by an electing § 1111(b) creditor is not entitled to the same treatment as the other impaired creditors.

14. On January 1, Debtor Inc., a company with more than \$100,000,000 in unsecured debt, filed a voluntary petition under Chapter 11. On February 1, a trustee was appointed in Debtor Inc.'s Chapter 11 case. Which of the following statements is correct (in the absence of a special court order)?

- a. Debtor Inc.'s right to file a plan terminated on February 1.
- b. A creditor may file a plan only if Debtor Inc. fails to file a plan within 120 days after January 1.
- c. A creditor may file a plan only if Debtor Inc. fails to file a plan that has been accepted within 180 days after January 1.
- d. A creditor may file a plan on or after February 1.

D is correct because the debtor's exclusive plan period expires upon the trustee's appointment under §1121(c)(1). A is incorrect because the debtor may file at any time under §1121(a). B and C are incorrect because they relate to time periods that would be applicable under §1121(c) if no trustee was appointed.

15. On January 10, Debtor Inc. filed a voluntary petition under Chapter 11 and a trustee was appointed. On February 10, the trustee deposed the pre-bankruptcy attorney of Debtor Inc. and inquired into the contents of pre-bankruptcy attorney-client conversations between the attorney and the officers of Debtor Inc. If the attorney refuses to answer and asserts the attorney-client privilege:

- a. the attorney-client privilege will prevent the trustee from discovering the contents of the conversations
- b. the attorney can be required to testify because the attorney-client privilege does not apply in a bankruptcy case
- c. the trustee can waive the privilege on behalf of Debtor Inc. and require the attorney to testify
- d. the trustee can not waive the privilege because Debtor Inc. is a corporation and only the Board of Directors can waive the privilege

C is correct under CFTC v. Weintraub, 471 U.S. 343 (1985).

16. At the time the Chapter 11 petition was filed, Debtor Inc.'s pre-bankruptcy accountant was in possession of certain records relating to Debtor Inc.'s financial affairs. Although the records relate to Debtor Inc., they are the property of the accountant. The accountant was paid in full before bankruptcy and has not filed a claim or otherwise appeared in the case. If the trustee seeks an order requiring the accountant to turn over the records:

- a. the accountant can block the turnover request by asserting the accountant-client privilege
- b. the accountant can be required to turn over the records because the accountant-client privilege does not apply in a bankruptcy case
- c. the accountant can block the turnover request by asserting his/her ownership of the records

- d. the bankruptcy court lacks jurisdiction over the accountant because he/she is not a creditor and has not filed a claim or otherwise appeared in the case.

B is correct because the accountant-client privilege is not recognized under federal law. In re International Horizons, Inc., 689 F.2d 996 (11th Cir. 1982). Thus A is incorrect. C is incorrect because §542(e) permits turn over regardless of ownership. D is incorrect because the § 542 power does not turn on the creditor status of the accountant.

American Board of Certification -- Sample Exam

Bankruptcy Ethics

Answer Two Questions out of Four

Total Time -- One Hour

NOTE: The following questions and sample answers are based on questions used in past examinations. The sample answers are based on the status of the law as of the date the questions were written. In some instances, the sample answer may no longer reflect the prevailing view of the law. Although an excellent paper would discuss in detail all of the issues raised in the sample answer, a paper may receive a passing grade even though the analysis is less thorough. Historically, approximately 80 percent of the Ethics papers have received a passing score.

QUESTION A

(Suggested Time - One-Half Hour)

You represent an individual in a Chapter 7 case who owns a vehicle pledged to secure the claim of Bank. The vehicle was purchased new in 2009. The monthly debt payments and insurance payments consume all of the individual's disposable income and actually exceed the rental payments on the Debtor's house. Even though it is not in the Debtor's best interest to keep the vehicle, the Debtor is proud of the vehicle and does not want to give it up. The Bank is willing to reaffirm the debt, but only if the original Note terms are reaffirmed. The vehicle is used primarily for pleasure and is not necessary for the Debtor's employment.

Can you represent your client in connection with a reaffirmation of the debt? Be sure to identify the state where you practice and indicate, if you know, whether the ethical rules in your jurisdiction are patterned after the ABA Model Code of Professional Responsibility (usually numbered as "DR 2-105," etc.), the ABA Model Rules of Professional Conduct (usually numbered as "Rule 7.4," etc.), or neither.

QUESTION B

(Suggested Time - One-Half Hour)

You represent a husband and wife who filed joint Chapter 7 petitions. Both Debtors received their discharges several months ago, but the case has not yet been closed. You have been contacted by the husband, who explains that his wife has filed for divorce. He wants you to represent him in the divorce case.

Can you represent him? Be sure to identify the state where you practice and indicate, if you know, whether the ethical rules in your jurisdiction are patterned after the ABA Model Code of Professional Responsibility (usually numbered as "DR 2-105," etc.), the ABA Model Rules of Professional Conduct (usually numbered as "Rule 7.4," etc.), or neither.

QUESTION C

(Suggested Time - One-Half Hour)

Your firm has represented Debtor Inc. for many years. The corporation has been slow in paying your fees, but always seems to come up with the money by the end of the year. The corporation has not made any payments in more than four months and currently owes the firm for fees and expenses extending over a six month period. Those fees relate to general corporate matters, and were not incurred in connection with or in contemplation of a bankruptcy filing.

Debtor Inc. has been unable to obtain an extension on its line of credit with Bank, and Bank is threatening to take immediate action to collect all accounts receivable. Debtor Inc. wants your firm to represent it in a Chapter 11 case and is willing to use its available cash to bring your firm current and to pay a retainer sufficient for you to undertake the representation. Debtor, Inc. also has unencumbered real property that it has offered to pledge to secure the payment of both past fees and future fees.

Please discuss the following questions. Be sure to identify the state where you practice and indicate, if you know, whether the ethical rules in your jurisdiction are patterned after the ABA Model Code of Professional Responsibility (usually numbered as "DR 2-105," etc.), the ABA Model Rules of Professional Conduct (usually numbered as "Rule 7.4," etc.), or neither.

- 1) May you represent Debtor Inc. in its bankruptcy case?
- 2) May you accept the proposed payments, retainer and pledge of unencumbered real property?

QUESTION D

(Suggested Time - One-Half Hour)

You represent Bank, which has a duly perfected security interest in the inventory and accounts receivable of Debtor Inc. Debtor Inc. has not asserted any challenge to the perfection of your security interest, but has not been willing to acknowledge that this interest is unavoidable. You, as counsel for Bank, are not aware of any facts that would support an avoidance claim of Bank's interest. A Trustee has been appointed in Debtor Inc.'s case and is in the process of liquidating assets. The Trustee has refused to give Bank relief from stay and asserts that the Bank is fully secured.

The Trustee has initiated multiple preference actions against various trade creditors. The local rules require local counsel to represent any corporation in Bankruptcy Court. Your firm has been contacted by several preference defendants to represent them on the preference actions that have been brought against them. Each of the actions was brought as a separate adversary proceeding, and all are unrelated to each other.

Please discuss the following questions. (Be sure to identify the state where you practice and indicate, if you know, whether the ethical rules in your jurisdiction are patterned after the ABA Model Code of Professional Responsibility (usually numbered as DR 2-105," etc.), the ABA Model Rules of Professional Conduct (usually numbered as "Rule 7.4," etc.), or neither.)

- 1) May you represent the Bank and one of the trade creditors?
- 2) May you represent more than one of the trade creditor?

SAMPLE ANSWER TO QUESTION A:

Under § 524(c) any reaffirmation agreement which is filed with the court must be accompanied by a declaration of the Debtor's attorney stating that the agreement does not impose an undue hardship on the Debtor or a dependant of the Debtor. Under the facts of this case, it appears clear that any reaffirmation would impose an undue hardship on the Debtor and, thus, the attorney could not truthfully make the required declaration. The § 524 declaration presents a conflict for the attorney between his/her duty to zealously represent the client and the duty of candor owed to the court. Because the ethical rules prohibit the lawyer from making false statements in connection with his/her representation of the client, the lawyer must decline to file the declaration. The following options are available:

1. The attorney can withdraw as the Debtor's attorney and the Debtor could present the agreement to the court pursuant to § 524(c)(6) under which the court must approve the agreement as not imposing an undue hardship on the Debtor and being in the best interest of the Debtor.
2. Convince the Debtor that the Debtor should not enter into the reaffirmation agreement and should surrender the vehicle and purchase a less expensive means of transportation.
3. Explore the feasibility of the Debtor confirming a Chapter 13 plan and consider conversion to Chapter 13.

The key issue is that the attorney recognizes the dilemma caused by having to file an attorney declaration with the reaffirmation agreement.

SAMPLE ANSWER TO QUESTION B:

Two related problems are presented here. First, the attorney has an obligation to both the husband and the wife to protect confidences and secrets. Further, the attorney should not use information acquired in the course of representing a client to the disadvantage of the client. This obligation continues after the termination of the employment. Here, it is likely that the attorney may have learned quite a bit about the wife's assets, interests, etc. that might be used against her in the divorce action. If so, then the representation would not be proper.

Next, the attorney must consider the potential for a conflict of interest. The analysis varies depending upon whether the attorney has completed the representation of the joint Debtors. If both Debtors are current clients, then the general rule would prohibit the proposed representation because the Debtors are directly adverse in the divorce action. Further, this conflict probably could not be waived because representation of the husband in the

divorce likely would adversely affect the attorney's relationship with the wife. Here, since the Chapter 7 case has not been closed, the representation would be continuing. Even if the representation has been concluded, there may still be a conflict that prevents the representation of the husband. The lawyer must first determine whether the divorce action is substantially related to the bankruptcy and whether the obligations to the wife (the duty of confidentiality for example) will impair his/her ability to exercise independent professional judgment. Because many issues will overlap, it is likely that the matters are substantially related and thus, the attorney must make full disclosure to the wife and gain her consent before representing the husband in the divorce. However, if the duties to the wife (such as confidentiality) will adversely affect the attorney's representation of the husband, the representation should be declined.

The key issue is that the attorney recognizes the obligation to protect confidences and secrets of the wife and recognize the conflict of interest.

SAMPLE ANSWER TO QUESTION C:

1. Section 327 permits a debtor to employ an attorney that is disinterested as defined under § 101(14) and does not hold or represent an interest adverse to the estate. Technically creditor status would cause the attorney not to be disinterested under § 101(14). Thus, to represent Debtor Inc. either you must waive your pre-petition fees or be paid in full prior to the filing of the bankruptcy petition. The acceptance of payments, however, may disqualify you as well. While you may be disinterested as technically defined under the Code, the acceptance of a preference may cause you to hold or represent an interest adverse to the estate and thus still disqualify you under § 327. This is a fact issue that would be determined by the court on a case-by-case basis and would depend upon the amount of the preference and perhaps the likelihood that the creditors would not be paid in full.

2. Debtor's cash – that it proposes to use to pay your bill and to create the retainer – may constitute proceeds of Bank's collateral. Generally a transferee of money takes it free of a security interest unless the transferee acts "in collusion" with the debtor in violating the rights of the secured party. UCC § 9-332(a). As a lawyer, you may be found to be acting in collusion, in which case the funds would remain subject to the Bank's security interest.

Most courts have permitted security interests intended to secure post-petition services. The most notable of these is In re Martin decided by the First Circuit in 1987. Securing pre-petition fees would mean that the firm is a creditor and thus not disinterested. It would also constitute a preference and would be avoidable. In considering whether a pledge of assets to secure post-petition fees should be allowed courts look at such factors as:

1. Reasonableness of the arrangement.
2. Whether the fee arrangement was negotiated.
3. Whether the security was commensurate with the magnitude and value of the future services.
4. Whether the security was a necessary means to insure engagement.
5. Whether there are signs of overreaching.
6. The nature and extent of any potential conflict of interest.
7. The likelihood that the potential conflict may turn into an actual conflict.
8. Whether the potential conflict may influence the attorney's subsequent decision making.
9. Whether the arrangement appears improper to other parties in interest.
10. Whether the existence of the security interest threatens to hinder or delay effectuation of a plan.
11. Whether fundamental fairness may be unduly jeopardized.

SAMPLE ANSWER TO QUESTION D:

1) A lawyer should exercise independent professional judgment on behalf of a client. This means that the lawyer must weigh carefully the possibility that his judgment may be impaired or his loyalty divided if he accepts or continues employment of multiple clients. He should resolve all doubts against the propriety of the representation and should not represent in litigation multiple clients with different interests if that would adversely affect the representation. If the interests vary only slightly and he can retain his independent judgment on behalf of each client, the client must be given the opportunity to evaluate his need for representation free from potential conflict and obtain other counsel if the client so desires. Thus, the attorney must make full disclosure to the clients and obtain their consent to the multiple representations. It would also be important for the attorney to consider the disruptive effect that withdrawal might have if the potential conflicts of interest become actual conflicts.

There always exists a conflict between a secured creditor and an unsecured creditor. In this case, even though the security interest of Bank

appears to be uncontested, it has not been determined to be valid and thus is subject to attack by other creditors. Additionally, the value of the collateral has yet to be determined and the parties may have different interests as to how the property would be sold. Thus, it would be problematic for a firm to represent both an unsecured and a secured creditor unless all issues regarding the security interests and the value of its collateral have been previously determined.

2) As for representing more than one of the trade creditors, it is likely that their interests would be very similar, although the goal of each creditor is to maximize the preference recovery from the other creditors and minimize the preference recovery from that creditor. Once the amount of the claims is determined, however, the interests would be identical. Whether you could represent more than one defendant in a preference action would be determined on a case-by-case basis. Important factors would be:

1. The amount of the preference claim in relation to the other potential clients; and
2. The common defenses that the parties may have.

If the amounts are relatively equal and the defenses are the same, then it is likely that the attorney would be able to represent each without impairing his independent professional judgment. A practical problem exists in small communities where there may be more claims than attorneys. In such instances, competent local counsel may be very difficult to find unless local attorneys represent multiple clients.

**American Board of Certification -- Sample Exam
Business Sub-Specialty Essay
Answer Two Questions out of Three Questions
Total Time - 3 Hours plus a 15 Minute Reading Period**

NOTE: The following questions and sample answers are based on questions used in past examinations. The sample answers are based on the status of the law as of the date the questions were written. In some instances, the sample answer may no longer reflect the prevailing view of the law. Although an excellent paper would discuss in detail all of the issues raised in the sample answer, a paper may receive a passing grade even though the analysis is less thorough. Historically, more than 90 percent of the Business papers have received a passing score.

Question A
(Suggested Time - 1 1/2 hours)

Martin Financial Printers, Inc. (MFP) filed a Chapter 11 petition on January 2, 2009. MFP is a financial printing company and has been in the financial printing business for over eighty years. It is a privately held corporation whose stock is owned equally by four individuals - - Joan Mead, Tamar Venter, Joseph Gerten, and Arielle Zorne. Mead, Venter, Gerten, and Zorne also serve as the principal officers and as directors of MFP.

In December, 2004, MFP obtained a five year term loan of \$5 million from FirstBank to provide working capital for the business. Under the terms of the loan, MFP was obligated to pay interest only on a quarterly basis at prime + 2 points and to repay the principal in December, 2009. MFP last paid interest on the loan on October 7, 2008. At the time the loan was made in 2004, the bank took a security interest in all of MFP's inventory and equipment, now owned and hereafter acquired. Unfortunately, through an oversight, the bank failed to file a financing statement to perfect its interest until after it performed a troubled loan review in November of 2008. On November 18, 2008, the bank filed a U.C.C. financing statement with the Secretary of State in the state in which MFP was incorporated, as required under the relevant state law to perfect its security interest.

In September of 2007, MFP borrowed \$2 million from CPI Finance Co. The loan was provided on an unsecured basis but was guaranteed by Mead, Venter, Gerten and Zorne. Under the terms of the loan, MFP was required to pay 12% interest to CPI on the 15th day of each month and was required to repay \$1 million of the principal on September 1, 2008, and the other \$1 million of principal on September 1, 2009. However, CPI was entitled to demand repayment earlier if it deemed itself insecure.

Unfortunately, MFP was adversely affected by the recession and by the decline in financial printing business caused by the increase in desktop publishing. By late in the summer of 2008, the principals of MFP began to realize that the company was in severe financial difficulty. Cash flow was insufficient to cover MFP's obligations, trade creditors were less willing to continue supplying on credit, and MFP had difficulty raising fresh cash.

On September 1, 2008, CPI demanded payment of the \$1 million installment due on that date and suggested that MFP might want to repay the balance of the loan at the same time. One of the few obligations that MFP had been careful to remain current on was the CPI loan. In fact, MFP had made its regular interest payments to CPI on the 15th day of each month as required by the loan agreement. When it received the CPI demand for payment of principal, MFP asked for some time to get some money together. CPI gave MFP two additional weeks and on September 15, 2008, MFP paid CPI the entire \$2 million principal.

The \$2 million payment constituted a further drain on MFP's resources and its financial difficulties increased thereafter. In an attempt to preserve cash, MFP failed to remit to the Internal Revenue Service its October payment of employment taxes and taxes withheld from its employees' wages and instead used the money to meet demands from trade creditors. However, on December 30, recognizing that MFP's principals might be liable for penalties for MFP's failure to remit trust fund taxes, MFP paid the withheld taxes to the IRS. At the same time, MFP paid the employment taxes that had been due in October.

On January 2, MFP filed a Chapter 11 petition. In its schedules, it listed debts totaling \$10 million and assets of \$4 million, which consisted primarily of inventory and equipment.

The following specific issues have arisen in the MFP bankruptcy. Please analyze each of the issues in light of the facts and suggest both legal and strategic approaches to each issue.

1. FirstBank has asserted a secured claim in MFP's bankruptcy proceeding. MFP, as debtor in possession, would like to invalidate FirstBank's security interest and also to recover the October, 2008 interest payment made by MFP to FirstBank. Discuss the legal theories that can be asserted by MFP, any defenses available to FirstBank, and decide who would likely win.

2. Discuss whether MFP can recover any of the interest payments made in 2008 to CPI or the \$2 million repayment of principal that was made on September 15, 2008. Discuss any defenses that might be raised. If you determine that MFP could recover any such payments, discuss why MFP might not choose to pursue the action and what might happen in that event.

3. Discuss whether MFP can recover any of the December payments that it made to the IRS.

4. When Mead, the president of MFP, purchased his new house in February of 2008, he obtained a \$1.5 million mortgage loan from County Bank. MFP guaranteed Mead's obligation under the mortgage loan. Mead has defaulted on his obligation to County Bank, the bottom has fallen out of the real estate market so that the fair market value of the house is now less than \$1 million, and County Bank has filed a claim in the MFP bankruptcy, seeking to enforce the guaranty. Discuss whether MFP, as debtor in possession, can successfully object to County Bank's claim and analyze the theories that MFP would use and any defenses available to County Bank.

5. On January 3, 2009, in response to MFP's bankruptcy filing, FirstBank froze MFP's bank account, which had a balance of \$200,000. FirstBank has filed a motion seeking permission to set off the balance of the account against its \$5 million claim, or, in the alternative, seeking a court order confirming that it has a \$200,000 secured claim and conditioning MFP's use of the funds in the account on its provision of adequate

protection of the bank's interest in the funds. MFP has responded by asserting that the balance in the account increased from \$25,000 ninety days before bankruptcy to \$200,000 on the date of the commencement of the case and has argued that the bank's interest in the account should be limited to the balance 90 days before bankruptcy. Discuss (a) whether the bank's right of setoff is limited to \$25,000 or is available for the entire account balance; (b) whether the bank has a secured claim with respect to the funds in the account; and (c) whether the bank is entitled to adequate protection prior to the debtor's use of the funds in the account.

6. Tacoma Paper Supply delivered \$20,000 of paper to MFP on October 15 on unsecured, 30 day payment terms. MFP never paid for the paper. On January 3, as soon as it learned of MFP's bankruptcy filing, it sent a letter to MFP demanding return of its paper. Discuss whether Tacoma Paper will be able to recover its paper or, if not, whether it will be entitled to any other remedy. Consider whether FirstBank's security interest will have any effect on your analysis.

7. Several employees have filed secured claims against MFP for wages accrued but not paid during December, 2008. They base their claim for security on a state statute that gives employees of a business a senior lien on all assets of an insolvent business to secure unpaid wages. Under the applicable statute, the lien is available only if the business is insolvent. MFP has objected to the employees' secured claim. Discuss whether MFP's objection is likely to be successful and whether the employees might have any other basis for demanding better treatment than other creditors.

SAMPLE ANSWER TO QUESTION A:

1. The debtor in possession has the rights of a bankruptcy trustee. The DIP can use the preference avoidance power to avoid FirstBank's security interest. Although the security interest was granted to FirstBank long before the preference period, § 547(e) provides that the "transfer", for purposes of § 547, occurred when the security interest was perfected. Therefore, there was a transfer of a security interest in November, 2008 which was on account of an antecedent debt, within 90 days before bankruptcy, etc. If FirstBank is entitled to assert the secured claim, it would receive more than it would have received in a Chapter 7 liquidation without the transfer. Therefore, the security interest is avoidable.

The interest payment probably cannot be avoided. FirstBank can argue that the payment is protected under § 547(c)(2), the ordinary course of business exception. The loan was obtained in the ordinary course of MFP's business (to provide working capital), was made according to ordinary business terms, and the payment was made more or less on time in a reasonably expectable manner. The ordinary course of business exception applies to payments on long term debts as well as to payments on short term debts.

2. Because the loan was guaranteed by insiders, MFP's payment of the principal and interest benefitted the insiders by relieving them of their obligations on the

guarantees. Because the payments benefitted insiders, they constituted insider preferences. As insider preferences, these payments are subject to the one year insider preference period rather than the normal 90 day period. However, these preferential payments are recoverable only from the insiders benefitted by the payments, not from the non-insider payee, CPI. § 550(c)(2). Therefore, the avoidance action would have to be brought against the insider-guarantors, and they would raise any available defense.

They might argue that the payments were in the ordinary course of business and are exempted from preference attack. The interest was regularly paid on a timely basis and could easily be fit within the ordinary course of business. The \$1 million principal payment that was due on Sept. 1, 2008 might be considered ordinary course since the loan was an ordinary course loan and was paid in a reasonably timely fashion. It would be difficult to maintain that the other \$1 million (due in 2009) was an ordinary course payment.

Even with respect to the interest and the first million dollar payment, MFP will argue that the payments were not in the ordinary course of business and did not fit within the ordinary course exception to preference avoidance. The payments clearly benefitted insiders and would likely have been made even if there was not enough money to pay other obligations. Particularly with respect to the \$1 million principal repayment, it seems unlikely that a debtor in financial difficulty would pay a substantial obligation without any attempt to renegotiate the terms of the transaction. MFP might also argue that the delay in paying the \$1 million takes the payment out of the ordinary course. It would be necessary to determine whether MFP normally made payments late.

An attorney for MFP would be in a somewhat conflicted position with respect to this preference claim. Since the guarantors are the officers and directors of the DIP, they are unlikely to want to pursue the alleged preference. Yet the debtor may owe a fiduciary duty to the other creditors to actively pursue the preference. The attorney should remember that he or she is a representative of the estate, not the principals.

If the debtor did not pursue the action, the creditors' committee might seek authority to pursue the action on behalf of the debtor. Although the creditors' committee could seek a court order directing the DIP to pursue the action, the debtor might not energetically prosecute an action that is unfavorable to its officers and directors. Therefore, the creditors' committee should seek authority to pursue the action itself, on behalf of the debtor, or seek the appointment of an examiner or trustee with special limited powers to do so.

3. Payment of the trust fund taxes is probably not recoverable because the money withheld from employees' wages would not be considered property of the estate. Payment of the employment taxes may be recoverable as a preference notwithstanding any assertion of sovereign immunity under the authority of *Central Virginia Community College v. Katz*, 546 U.S. 356 (2006). In any case, because the government's tax claim

is entitled to priority under § 507, it may well be that the government did not receive more than it would receive in a Chapter 7 liquidation without the payment and therefore may not be recoverable as a preference.

4. MFP would argue that the guaranty is a fraudulent conveyance avoidable under sections 544(b) and 548. The fraudulent conveyance law enables the trustee to avoid both transfers and obligations made or incurred with actual intent to hinder, delay or defraud creditors or for less than reasonably equivalent value while the debtor was financially impaired.

Here, it may be difficult to show that the debtor's guaranty obligation was incurred with actual intent to hinder, delay or defraud creditors. With respect to constructive fraud, it seems unlikely that the debtor has received reasonably equivalent value in exchange for the obligation it undertook. The entire benefit of the loan seems to have gone to Mead, the insider. However, County Bank might argue that at the time the guaranty was given the present value of the potential liability was far less than \$1.5 million and that the guaranty was simply part of Mead's compensation package. If so, arguably the debtor received reasonably equivalent value in the form of services performed by Mead. Consideration flowing from a third party, Mead, may be sufficient to enable County Bank to avoid a fraudulent conveyance attack.

5. (a) The bank's right of set off is available for the entire balance of the account. If the bank had set off pre-petition, its setoff right would have been limited by the improvement in position test in § 553(b). However, by waiting until after the debtor filed its petition, the bank avoided the operation of § 553(b), which applies only to pre-petition setoffs.

(b) The bank's right of setoff gives it a secured claim under section 506, which explicitly recognizes setoff rights as one class of secured claims.

(c) The funds in the account are cash collateral. As such, section 363 provides that the debtor may not use the funds unless the bank agrees to the debtor's use or the court approves the debtor's use of the funds. Court approval is conditioned on the debtor's provision of adequate protection to the bank.

6. Bankruptcy Code § 546(c) permits a seller who has sold goods to the debtor in the ordinary course of the seller's business to reclaim the goods if the debtor received the goods while insolvent within 45 days before the commencement of the case. Under § 546(c), the seller must make written demand within 45 days after debtor's receipt of the goods, or 20 days after commencement of the case, whichever is longer. The seller seems to have done so in this case. The delivery must have been in the ordinary course of business, which is probably the case with respect to delivery of paper to a printer.

The § 546(c) right of reclamation is “subject to the prior rights of a holder of a security interest in such goods or the proceeds thereof.” Therefore, generally the secured creditor, FirstBank, would defeat the right of reclamation.

Here, however, the DIP has the power to avoid the security interest as a preference. This would have no effect on the analysis, however, because the security interest is preserved for the benefit of the estate under § 551. Arguably, when the trustee steps into the shoes of the secured party the trustee gets the secured party's priority over the reclaiming seller.

These goods were not delivered within 20 days before commencement of the case and therefore are not subject to the automatic administrative expense priority conferred by § 503(b)(9).

7. The liens claimed by the employees are statutory liens. Because the liens are effective only against insolvent debtors, these liens are avoidable as statutory liens under Bankruptcy Code § 545. Thus, the employees have unsecured claims.

Nevertheless, the employees are entitled to some priority under § 507. Wage claims are entitled to fourth priority up to a maximum of \$10,950 per employee for wages earned within 90 days before bankruptcy. Here, the wages were earned within a month before bankruptcy so the employees could receive a fourth priority for up to \$10,950 each.

Question B **(Suggested Time - 1 1/2 hours)**

Bike America, Inc. ("Bike") operates a chain of 25 bicycle retail stores in the Rocky Mountain region. Fifteen of the stores offer a full range of bicycles for sale, with much of their inventory in the low to mid-price range. These stores have continued to do decent business, showing a modest profit. Three years ago Bike opened ten new stores, which emphasized very expensive, high-tech bikes. This proved to be a bad business decision, as these ten stores have experienced large losses.

Bike has been financing its inventory with Merchant's Bank through a floor plan arrangement. Merchant's Bank has a perfected security interest in Bike's "presently owned or hereafter acquired" inventory, and provides a line of credit to Bike, subject to various restrictions. As of May 1, 2009, Bike's debt to Merchant's Bank was \$3 million. Bike had missed the payment to Merchant's Bank due on April 30. This was the fifth time in the last year that Bike had missed a payment. Merchant's Bank declared the entire balance due effective May 1, and on May 7 seized the inventory in five of the more profitable stores. The inventory seized has an estimated going concern value of \$600,000, and a liquidation value of only about \$400,000. All of Bike's inventory (including that repossessed by Merchant's Bank) has a going concern value estimated at \$2.8 million; the liquidation value of that same inventory is projected roughly at around \$2 million.

To prevent Merchant's Bank from repossessing any more inventory, Bike filed a Chapter 11 petition on Friday, May 8, 2009.

In order to have a chance to reorganize its business, Bike needs to accomplish several goals in the immediate future:

a. Get the repossessed inventory back from Merchant's Bank, and reopen the five stores which had to close after Merchant's Bank seized the inventory. Time is of the essence, or customer goodwill will be irretrievably lost.

b. Operate the fifteen profitable stores (including the five currently closed), selling and replacing inventory on a normal business basis.

c. Obtain a new floor plan lending arrangement during the Chapter 11 case, either with Merchant's Bank or with a new lender.

d. Close the ten unprofitable stores. Bike would like to sell the inventory, and assign its store leases, which are at a very favorable rate.

You are counsel to Merchant's Bank. They have told you that their primary objective is to realize the maximum amount of money on the Bike loan, without unnecessary further risk. They are open to the possibility of doing the DIP financing, but are not exactly enthusiastic at the prospect. They show you the above list of Bike's short-term goals, which Bike gave them in a meeting on May 11. Right now Merchant's Bank wants to know what its rights (or lack thereof) is in Bike's Chapter 11 case. Specifically, in a meeting on May 15, they ask you the following questions:

1. May they go ahead and foreclose their security interest in the inventory in their possession by compliance with Article 9 procedures? May they repossess any additional inventory of Bike?

2. If they need to get court permission to repossess the remaining inventory and to foreclose their security interest in any or all of that inventory, what do they have to show, and what are their chances of succeeding? How are the burdens of proof allocated? Is Merchant's Bank entitled to any form of protection? If it does not receive court permission now to repossess and foreclose, will that decision be res judicata as to all future attempts to get such court permission?

3. Can Bike get back the repossessed inventory over Merchant's Bank's objection?

4. May Bike sell Merchant's Bank's inventory collateral to customers in the regular course of business over Merchant's Bank's objection?

5. May Bike sell the inventory subject to Merchant's Bank's security interest in the ten stores to be closed over Merchant's Bank's objection? Would such a sale have

to take place pursuant to a confirmed reorganization plan? Would Merchant's Bank have an opportunity to bid on that inventory at any such sale?

6. Will Merchant's Bank's security interest attach to any inventory Bike may acquire during the Chapter 11 case?

7. Can Bike compel Merchant's Bank to continue lending money to Bike under the terms of the pre-petition floor plan arrangement?

8. If Bike wants to borrow from another lender in the Chapter 11 case, what can it offer that prospective lender? Merchant's Bank particularly wants to know if its collateral position is safe.

9. If Merchant's Bank does want to provide the DIP financing, could it insist on terms which would collateralize its entire pre-petition claim with assets of the estate?

SAMPLE ANSWER TO QUESTION B:

1. No. The § 362(a) automatic stay would prevent First Bank from foreclosing its security interest in the collateral and from repossessing any more collateral.

2. First Bank will have to move for relief from the automatic stay under § 362(d)(1) or (2). A determination on a stay relief motion is not res judicata as to any future stay relief motion.

Under (d)(1), relief will be granted for "cause, including the lack of adequate protection." Bike as DIP has the burden of proof on adequate protection [§ 362(g)(2)]. First Bank is entitled to adequate protection, as defined in § 361 of its "interest ... in property." Possible forms of protections are cash payments [§ 361(1)] or replacement liens (§ 361(2)) to First Bank to the extent the stay results in a decrease in the value of First Bank's interest in the collateral. The "indubitable equivalent" also may be provided. [§ 361(3)]. However, an administrative priority does not qualify as adequate protection. Nor does adequate protection include compensation to First Bank for the lost opportunity cost based on being delayed in foreclosing its security interest, according to the Supreme Court in Timbers. In this case, First Bank would be entitled to compensation (cash payments or replacement liens, probably) in the amount that its collateral is declining in value. Evidence of the rate of depreciation and of the rate the inventory is being depleted would be important. Bike as DIP at a minimum would have to show that the collateral was adequately insured and was being properly maintained and cared for.

It is difficult to assess First Bank's chances of succeeding under § 362(d)(1), without knowing the rate of depreciation of the collateral on the one hand, and the available cash (now in hand or expected out of future sales) or unencumbered assets that Bike may have on the other. To the extent that Bike is selling off inventory collateral in its business, First Bank should receive replacement liens in Bike's new inventory and in accounts. An interesting problem is whether First Bank is entitled to be

compensated for the decline in the value of existing inventory due to increasing obsolescence.

Under (d)(2), relief will be granted if (A) the debtor does not have an equity in the property and (B) the property is necessary to an effective reorganization. Bike as DIP has the burden of proof on necessity to an effective reorganization; First Bank has the burden of proof on the debtor's equity. § 362(g). Under the facts given, First Bank should be able to carry its burden of showing no equity under § 362(d)(2)(A). The debt of \$3 million is secured by collateral which at most under a going concern valuation would be worth \$2.8 million. Bike under § 362(d)(2)(B) would, under the majority view, have to show both that the property was necessary to a successful reorganization and that such a reorganization was feasible, i.e., a "reasonable possibility of a successful reorganization within a reasonable time." The Supreme Court approved this formulation in dictum in Timbers. A minority of courts (e.g., Koopmans) holds that the debtor only has to show necessity, with feasibility tested instead under a § 1112 motion to dismiss or convert.

As to the inventory in the fifteen stores that Bike wants to continue to operate, the necessity component of the test would seem to be met. It would be very hard for Bike to reorganize without its bicycle inventory. While these bicycles are not unique, and thus in theory Bike could let First Bank have its collateral back and then obtain new inventory after borrowing from another lender, the reality is that doing so would probably doom Bike's business. The business would be disrupted; furthermore, significant transaction costs would be incurred. The answer is less certain with regard to the inventory in the ten stores that Bike intends to close. First Bank obviously has a better case, because that collateral is going to be sold one way or the other. It is not certain, however, that the bankruptcy court would lift the stay and let First Bank foreclose. Indeed, it is more probable that the court will allow Bike to remain in possession and supervise an orderly liquidation of that inventory, with First Bank's security interest attaching to the proceeds of the sale. This issue is explored more fully in question 5 below. First Bank should be aware that even then it may not get its hands on the proceeds, if the court decides to permit Bike to use the "cash collateral" under § 363(c) to fund operation of its ongoing business. Again, adequate protection would have to be given to First Bank.

The feasibility part of the § 362(d)(2)(B) issue is even less promising for First Bank. Early in the chapter 11 case (the stage we now are in) the bankruptcy court is likely to give the DIP considerable leeway and find sufficient hope of a successful reorganization to continue the stay in effect for some period of time. This will allow Bike an opportunity to restructure its business operations and move toward confirmation. First Bank's chances for an immediate victory under § 362(d)(2) are probably not good, because Bike is operating fifteen stores at a modest profit, and has announced its intentions to close the ten unprofitable stores. Such a plan is not unduly speculative. First Bank could seek to have the court put Bike on some sort of a schedule, and revisit the issue at that time if Bike has not made satisfactory progress toward confirmation.

3. Yes. Under the turnover provision, § 542(a), Bike can obtain a court order directing First Bank to return the collateral to Bike, contingent on the provision of adequate protection to First Bank. The Supreme Court confirmed this reading of § 542(a) in Whiting Pools. The collateral is property that the DIP may use under § 363, subject to the provision of adequate protection. Further, the property is not of "inconsequential value or benefit to the estate," despite the lack of equity, because Bike needs the property in its reorganization, as discussed under question 2. Indeed, the turnover analysis dovetails with the analysis under § 362(d).

4. Yes, under § 363(c)(1), unless the court orders otherwise. The debtor as DIP is authorized to operate the business (as required to trigger § 363(c)(1)) under § 1108, unless the court orders otherwise. Therefore, the burden here is on First Bank to get a court order restricting Bike's sales of the inventory if it deems that necessary. It is difficult to imagine that First Bank could persuade the court to enter such an order, except as to limited matters such as accounting. The proceeds of the sales would be cash collateral subject to First Bank's security interest, and then subject to the special limitations on Bike's use under § 363(c)(2).

5. Bike may sell the inventory in the ten stores to be closed over First Bank's objection, pursuant to § 363(b)(1) and Rule 6004. If First Bank objects, court approval will be required. Absent objection, the sale could take place without specific court authorization. For the sale to be free and clear of First Bank's security interest, one of the conditions of § 363(f) must be met. The sale probably would not have to take place pursuant to a confirmed reorganization plan. Although some courts have restricted the ability of a DIP to sell all or substantially all of its assets outside of a plan, most courts have permitted such pre-confirmation sales if the DIP could establish a good business reason for not waiting until the plan. Regardless, in this case inventory in only 10 or the 25 stores is involved, so the scope of the sale probably does not even rise to the level where the extra protections of the plan are required, under whatever test. First Bank would have an opportunity to bid at such a sale under § 363(k), unless the court orders otherwise. First Bank then could offset its claim against the purchase price of the property.

6. This depends on an application of § 552. We will assume that outside of bankruptcy, First Bank's security interest would attach to after-acquired inventory. Nevertheless, under § 552(a), property (here, inventory) acquired after the filing of the chapter 11 case is not subject to prepetition security interests. This provision cuts off the after-acquired feature of floating liens. However, § 552(a) is subject to § 552(b). Subsection (b) provides that the creditor's security interest will attach to property acquired post-petition if that property is proceeds, etc., of the prepetition security interest. The extent of the proceeds coverage probably will depend on the ability of First Bank to trace its collateral into different forms. Even if the § 552(b) proceeds exception initially applies to protect the creditor, the court still may order otherwise, based on the equities of the case. For example, if the conversion of inventory into accounts requires the expenditure of other estate funds, as it surely

would (e.g., overhead, salaries, etc.), the secured creditor's collateral effectively can be charged with those expenses.

7. No. Under § 365(c)(2), financing agreements are not assumable.

8. § 364 governs permissible DIP financing inducements. Assuming again that Bike as DIP is authorized to operate the business under § 1108, a first priority administrative expense can be offered to the lender under § 364(a) unless the court orders otherwise (for ordinary course credit extensions -- probably not applicable here), and also under § 364(b), if approved by the court after notice and a hearing. If Bike can show that it is unable to borrow solely on the offer of an administrative priority, then under § 364(c) several possible extra benefits can be offered to the prospective lender, subject again to court approval after notice and a hearing. These are (1) a superpriority over all other administrative expenses, (2) a lien on unencumbered estate assets, or (3) a junior lien on encumbered assets. If Bike can show that it is not even able to borrow if the extra inducements of § 364(c) are offered to prospective lenders, then it might be able to convince the court to authorize a priming lien under § 364(d). This means that the new lender is given a lien senior or equal to First Bank in the collateral. Granting a priming lien under § 364(d) can only be done if First Bank, the primed creditor, is given adequate protection. Thus, First Bank's collateral position is safe in theory, but only if you believe that any adequate protection given to it will in fact be adequate. In this case, it is not clear what might be offered as adequate protection. If the court believed that future sales would generate enough assets to both pay off the new lender and protect First Bank's primed position, adequate protection might be found. The new lender also will be granted protection under § 364(e) from a reversal on appeal, if the financing order was not stayed, as long as it was in good faith.

9. Although controversial, most courts will allow a prepetition lender who does the DIP financing to obtain "cross-collateralization," which means that post petition assets are used to secure the lender's prepetition claim. In this case such a cross-collateralization clause might have some effect, because First Bank is undersecured prepetition. The courts that do allow cross-collateralization first insist on notice and an opportunity to object for unsecured creditors. Substantively, the courts will require a showing that the financing is necessary to the reorganization, that alternative financing on better terms could not be obtained from this lender or any other, and that the proposed financing is in the best interests of the creditors and the estate. The court will not approve the financing if it believes it is being done primarily to advance the interests of First Bank, as opposed to benefiting the estate. In this case, if no other lenders could be persuaded to do the DIP financing on favorable terms, it is likely that cross-collateralization in favor of First Bank would be approved. A minority of courts will not approve cross-collateralization, which they believe runs contrary to the equality principle in the Code.

Question C
(Suggested Time - 1 1/2 hours)

Oakdale Vineyards, Inc., (Debtor) is a wine producer. Oakdale has substantial debts and has been involved in labor difficulties. The assets of the debtor include:

Assets:

Vineyards	\$500,000
Plant & Equipment.....	\$1,000,000
Inventory	
Reds	\$550,000
Whites	\$50,000
Receivables	\$300,000

Debts include:

Secured:

Agribank Vineyard mortgage	\$700,000
Citebank winery plant and equipment loan	\$650,000
Citebank inventory and receivables loan	\$600,000
Owner's equipment loan.....	\$500,000

Unsecured:

Grape Supplier contract.....	\$250,000
Union claims.....	\$100,000
Unsecured trade debts	\$500,000

Debtor filed Chapter 11 on February 1, 2009. Prior to filing, on October 15, 2008 John Owner deeded the vineyard properties to the Debtor. Owner is Debtor's principal stockholder. The deed was a result of a workout structure with Citebank in which it was agreed that all of the assets of the wine business should be pledged to Citebank. Owner's attorneys suggested that all the assets be placed in Debtor to ease the paperwork. Citebank thought that was an excellent suggestion and required that Owner also transfer to Debtor certain equipment he previously had been leasing to the corporation. The equipment transfer was made "in order to improve the debtor's balance sheet." Since the transferred equipment was worth \$500,000, the transaction was reflected as a \$500,000 loan to Debtor from Owner. To secure the loan, Owner took a security interest in the equipment transferred, second to Citebank on October 18, 2008. (Assume that all mortgages and security interests were properly documented and perfected.)

EVENTS OCCURRING DURING THE CHAPTER 11:

Union Contract Rejection.

Debtor successfully rejected the union contract with Winehaulers Local #12. Negotiations with the Union on a new contract are in progress. However, the Union claims \$100,000 damages from the rejection, based upon the wages, benefits and dues structure which has obtained since rejection and projected for the remaining 14 months of the rejected contract.

Agribank Motion for Relief From Stay.

Agribank moved for relief from stay claiming no equity and that Owner had transferred the vineyard to Debtor in bad faith and to obtain the automatic stay when the prospect of default and foreclosure was evident to Owner. Payments on the Vineyard loan are current. The court denied relief from stay finding that the vineyard, while not the principal source of grapes for the winery, was a part of the operation and was reasonably necessary to the success of the company. The court gave short shrift to the bad faith argument. The court noted that a mere pre-petition transfer of a single asset did not indicate bad faith and further stated that since the bank's payments were current it could not understand why the bank was making the motion at all.

Grape Supply Contract Rejected.

Debtor also rejected the contract with Grape Supplier to take pinot noir grapes at a specified quantity and price. Grape Supplier was required to sell into a falling market and has obtained the Debtor's stipulation to a \$250,000 loss as a result of the rejection. Grape Supplier has continued to work with the debtor post-petition and supplied much of the white wine grapes required by the debtor's strategy to get the quicker cash flow from white wine sales. Some have expressed concern that the debtor, by concentrating its efforts on white wine, has created a two year gap in the production of commercial quantities of red wines and that this gap will have the effect of reducing income in the period 2 to 5 years in the future.

Citebank Cash Collateral.

Debtor and Citebank have entered into a court approved cash collateral agreement. Debtor is within formula and Citebank appears content to continue the lending relationship if the Debtor achieves confirmation in a reasonable period of time. The agreements with the bank provide for 90 days notice of termination of funding absent default. There are no defaults at this time and none projected.

Plan and Disclosure Statement.

Debtor has just filed a plan and disclosure statement. The plan provides:

(class 1) Agribank be crammed down at a court determined interest rate for the remaining 15 years on the vineyard loan at the value of \$500,000.

(class 2) Citebank will be paid in accordance with its documents and is not impaired.

(class 3) Union and Grape Supplier rejection claims will be paid 25 cents on the dollar over 5 years.

(class 4) Unsecured creditors will be paid 50 cents on the dollar over 5 years.

(class 5) Stockholders will retain their stock but receive nothing on account thereof, and will be prohibited from receiving any dividends or redemptions until the unsecured payments under the plan have been completed.

Owner is contributing his \$500,000 secured claim as new capital as part of the plan.

The plan contains the requisite routine provisions required by chapter 11. The Plan also contains a class A and class P for administrative and priority claims respectively. There is sufficient cash to pay the administrative professional fees and court and U.S. Trustee charges. The Disclosure Statement (consistent with the debtor's schedules) reflects no priority claims. The Disclosure Statement projections are prepared by the Debtor internally and are stated to be "conservative." The projections indicate that there is just sufficient cash flow to service the payments set forth in the Plan.

Reaction to the Plan.

Grape Supplier (mysteriously) has indicated it will vote for the plan. The unsecured creditors committee supports the plan. Assume that class 5 will vote for the plan.

Union and Agribank seek to defeat confirmation of the Plan.

Thoroughly analyze and discuss the following:

1. State the arguments that Union and Agribank can make against confirmation of the Plan, and whether you think they would be successful.
2. If you represented Debtor, how would you change the plan to increase the likelihood of confirmation?

You may draw reasonable inferences from the facts given or add facts consistent with the behavior of debtors and creditors generally, but be sure to identify the inferences drawn and to discuss all the issues raised by the facts given.

SAMPLE ANSWER TO QUESTION C:

1. In order to confirm a chapter 11 plan, all requirements of § 1129(a) must be satisfied unless the plan is a cramdown plan.

The first possible objection is that the plan may not comply with the requirements of the Code as required by § 1129(a)(2). In particular, the classification of claims may be improper under § 1122. While the Code does not require that similar creditors be placed in the same class (here, all the unsecured creditors), the placement of rejection creditors in a separate class which received substantially less favorable treatment is discriminatory. Cases that seem to approve placing certain claims in separate classes due to differences in their relationship with the debtor may be cited by the Debtor. However, the Grape Supplier is friendly with the Debtor and presumably would prefer that the Debtor survive. The Union is not friendly, and absent a good contract result, would prefer to see the Debtor fail. By placement of these different creditors in the same class, the Debtor has lost some parts of the argument in support of separate classification.

The second possible objection seems to be under § 1129(a)(3): the plan has not been proposed in good faith. Now that Agribank is getting crammed down, the harm created by the pre-petition transfer is evident. Under the Plan as proposed, Agribank will not get all of its payments as contracted, whereas it would have been entitled to them if the vineyard were still owned by Owner. Note that the transfer was first suggested by Owner's lawyers, and not required by Citebank.

There does not seem to be any objection on the basis of the best interests test of § 1129(a)(7). In liquidation, the assets are all pledged to secured creditors and the unsecured creditors would get nothing.

The third objection is with respect to the vote under § 1129(a)(8). For confirmation of a non-cramdown plan, impaired class must vote to approve the plan. Approval requires a majority in number and at least 2/3 in amount of claims in the class. § 1126(c). Both class 1 and class 3 will be rejecting the plan (class 3 only contains 2 creditors with one voting no, so class three does not have more than 50% in number voting to approve). Therefore, the plan can be approved only as a cramdown under § 1129(b)

The final objection under § 1129(a) would be feasibility, § 1129(a)(11). The problems of the Union contract and the white wine cash flow situation raise questions about whether the reorganization is likely to succeed. It is easy to produce projections necessary to support a plan; performance is another matter. We do know that the debtor managed to convince the judge that it was in such sad shape that rejection of the union contract was necessary to the reorganization. With the union contract still in negotiation, and the historical balance of wine products (red and white) altered for expedience, feasibility should be attacked with expert testimony by a business person familiar with wine industry.

In a cramdown plan, Debtor must satisfy the requirements of § 1129(b), meaning that all of the requirements of § 1129(a) are met other than the required class vote, plus the plan must not discriminate unfairly and must be fair and equitable with respect to impaired dissenting classes.

As to Agribank, a secured creditor, the plan seems to satisfy the requirements of § 1129(b)(2)(A) by letting them retain their lien and receiving deferred cash payments totaling the allowed amount of their claim with interest at a court-determined interest rate intended to provide them the present value of their collateral.

As to the Union, the discrimination issue was discussed previously. In order to be fair and equitable, the plan must not allow any holder of a claim or interest junior to the dissenting class any property on account of such junior claim or interest. The plan contemplates that stockholders will retain their stock. Therefore, the question is whether the new value exception (assuming it exists) to the absolute priority rule has been satisfied.

First, it is uncertain whether the contribution of the secured claim constitutes new value at all. New value must be money or money's worth. Here there are no new funds or their equivalent coming to the company. However, if the claim were not forgiven, it would be entitled to be paid in the plan to the extent of the present value of its secured status, and foregoing that right to deferred cash payments may constitute new value. .

Second, does the new value exception exist? The Supreme Court has never definitively decided the issue, having most recently "assumed" its existence in 203 North LaSalle.

But even assuming that the new value exception exists and that Owner's contribution qualified, this plan does not implement a new value cram down properly because the original shareholders other than Owner also are receiving value under the plan before holders of claims in a rejecting class is paid in full, and they have provided no new value at all. Even if they provided new value, 203 North LaSalle suggests that giving them the exclusive right to obtain ownership of the reorganized debtor (rather than allowing others to subscribe on similar terms, or some sort of bidding procedure) violates the new value exception.

The conclusion is that this plan cannot be confirmed in its present form.

2. Several changes could be made to the plan to increase chances for confirmation.

First, shareholders should not receive any distribution under the plan. This eliminates any possible objection based on the absolute priority rule if a cramdown plan is necessary.

Second, work out something with Agribank. The vineyard is not the principal source of grapes for the business, so if Agribank cannot be induced to support the plan with a slightly higher interest rate (but one that the reorganized debtor can pay), the debtor can simply give Agribank the vineyard, transforming them into an unsecured creditor immediately.

Third, as to the unsecured creditors, place all rejection creditors and unsecured creditors in a single class, and pay them what is now offered to unsecured creditors. This would cost the company an additional 25 cents on the dollar for the Union and Grape Supplier claims, totaling \$350,000, or \$87,500 over five years. In exchange, this would dilute the voting power of the dissenting creditors (Union and, if Agribank can't be induced to support the plan, Agribank). Presumably you could then get a majority in number of unsecured creditors to support the plan. The total of Agribank's unsecured claim (\$200,000) and the union claim (\$100,000) is less than 1/3 of the total class of unsecured claims (\$1,050,000), and could not block an affirmative vote, unless they can designate Grape Supplier's claim on some basis.