I. BACKGROUND

A. Individual Bankruptcy

1. Two Types of Discharge

i. General Discharge

a. Court says you are clear, can walk away from all debts [727].

ii. Specific Discharge [523]

a. Court will discharge all debts, except for a few specific types of debts.

(1) Child support;

(2) Alimony

(3) Tortious debts

b. So Dr walks away from most debts but not all.

2. Exemptions

i. Some Assets are not grabbed and sold

B. Commercial Bankruptcy

1. Dr getting into trouble may do some bad things.

i. Preferential payment to Crs;

ii. Insiders begin looting the assets (Fraudulent Transfers)

iii. Company enters into bad deals (even if innocent)

iv. Bad executor contracts

2. Company decides to file bankruptcy petition

i. Triggers automatic stay

a. Everything stops (all Crs have to stop collection activity)

3. If company belongs in bankruptcy but refuses to file, another company/Cr can force the company into bankruptcy.

i. Potential for abuse

a. If you file an involuntary petition against someone when you shouldn't, you're liable in damages.

C. Types of Bankruptcy

1. Chapter 7

i. Liquidation = corporate death

ii. Run by Trustee

2. Chapter 11

i. Re-organization

a. 90% fail

ii. Run by Dr in Possession (DIP)

a. Same responsibilities as trustee

D. Duties of Trustee

1. Avoidance Powers

i. Trustee avoids (nullifies) certain Tx

a. Preferential, FT etc

2. *Enforce Automatic Stay*

3. *Object to Crs' Claims*

4. *Put Ch. 11 Plan together (if Ch. 11)*

5. *Accept or Reject Executor Ks*

6. *Obtain Financing for Ongoing Operations*

E. Generally, a Cr cannot enter into a K with a Dr company whereby the Dr company agrees not to file Bankruptcy

1. *Two Ways Around this Rule*

i. Bad Boy Clause

a. SH issues a personal guarantee to the lender.

b. Guarantee contains "bad boy clause"

(1) "I owe the lender $1M in event of default; but if there is a bankruptcy filing by the company I control, I owe $5M if I vote for bankruptcy."

(i) Problem here: Breach of FD by Gr, and aiding and abetting breach by lender.

ii. Special Purpose Entity Independent Director Appointment

a. Person owns an asset (RP); lender agrees to lend money on asset, but only if person puts the RP in a new company.

(1) Special Purpose Entity (SPE)

(2) Lender is involved in the incorporation.

(i) Articles contain provision that says as soon as there is a default, the lender gets to appoint an independent director to sit on SPE's board.

(ii) Independent director now represents interest of lender.

(a) Independent director will not vote for bankruptcy (which requires unanimity).

II. PREFERENTIAL TRANSFERS UNDER 547

GO TO E&E TO READ EXAMPLES FOR LEARNING ISSUE SPOTTING

A. Purpose of 547

1. Identify transfers that illegitimately prefer the Cr and that thereby undermine the collective process of bankruptcy and offend the bankruptcy goals of evenhanded treatment of Crs and preservation of the estate.
   i. "Avoid" = undue/nullify/void Tx

2. ***POSSIBLE TRIGGER*

   i. Transfer from Dr to Cr w/in 90 days of filing petition (or 1 year if Cr = insider); Cr has previously given consideration to the Dr for the transfer (i.e., a loan, etc.)

B. Statutory Construction

1. 547(b) has 5 Elements, all of which must be met.

2. If all 5 elements are present, the **trustee can** avoid a preferential transfer.

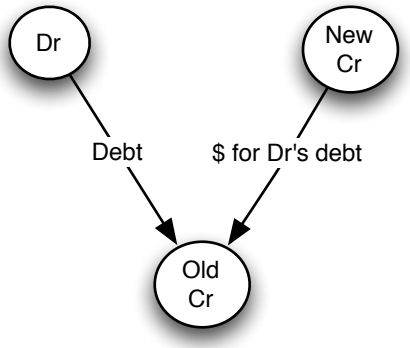
   i. If Chapter 7, then trustee does the avoiding;
   ii. If Chapter 11, then DIP does avoiding

3. If all 5 elements of 547(b) are present, look to 547(c) for an exception.

C. Elements of 547(b)

Burden is on the trustee to establish that a particular transfer was preferential.

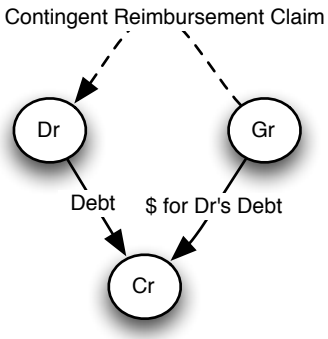
1. **There must have been a transfer of an interest in property of the Dr to or for the benefit of a Cr**. [547(b)]
   i. "*Transfer*" means: [101(54)]
      1. The creation of a lien;
         Basically a mortgage; transfer of an interest in property.
      2. The retention of title as a security interest;
      3. The foreclosure of a Dr's equity of redemption; or
      4. Each mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with either:
         (I) Property; or
         (II) An interest in property
         Basically says anything not in 1-3 = a transfer. Includes payments of cash (mode of partying w/property).
   ii. So doesn't have to be a transfer of actual property; can be an *interest* in property.
   iii. Is it a transfer of the Dr's property?
      1. **Earmarking**
         (I) 547(b) only allows avoidance of transfers of property of **debtor's estate.**
         (II) Question: To what extent did the Dr have **dominion and control** over the disposition of funds?
         (III) **Situation**: Dr owes debt to Old Cr. New Cr comes along and pays Old Cr for Dr's debt.



(1) If situation is just like diagram, then no preference, b/c Dr never had dominion and control over $.
(2) But at what point does the transfer become a transfer of Dr's property.
(i) Case specific.

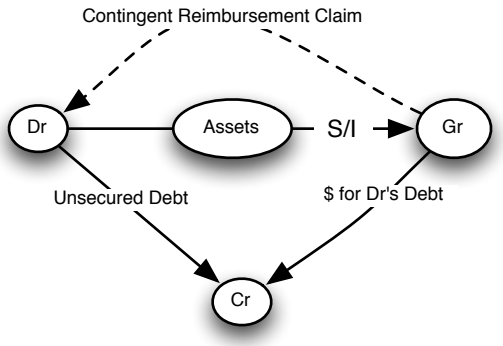
(IV) Common scenarios:

(1)



(i) No preference here.

(2)



(i) Here, the Gr's security interest in Dr's asset is not only for the benefit of the Gr, but also for the benefit of the Cr.

(a) So here, payment by the third party can trigger preference liability.

(b) Trustee can go after Cr for the value of the collateral (i.e., what Gr paid Cr) [550(a)(1)].

(3) Dr gets loan, then directs bank to pay loan proceeds to Crs.

(i) Courts are mixed

(a) Some courts say if money didn't pass through Dr's hands, then no preference.

(b) Other courts say if Dr had control, its as if it had possession, and therefore it is a preference.

2. The transfer must have been to or for the benefit of a Cr. [547(b)(1)]

i. Definitions

a. "*Creditor*" = Entity that has claim against Dr that arose at or before filing of petition. [101(10)]

b. "*Claim*" = right to payment.[101(5)]

ii. Analysis

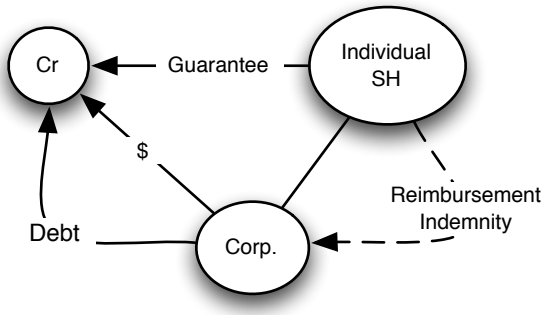
a. "To a Cr" = easy.

b. "For the benefit of a Cr" = indirect transfers that benefit Cr.

Look for payments to a Cr that reduce the liability of a 3rd party Gr

EXA:

(I)



(1) Gr has a reimbursement claim for indemnity against the corporation if Gr has to pay Cr on behalf of corporation.

(i) This indirect claim arises as soon as the SH issues the guarantee.

(ii) When the Dr pays money on the debt, this reduces the exposure of the Gr.

(a) So the SH has been made better off--this transfer (i.e., payment to the lender Cr) has been made for the benefit of the SH Cr.

3. The transfer must have been <u>made</u> for or on account of an antecedent debt. [547(b)(2)]

i. "*Antecedent debt*"

a. If the debt arose before the transfer was made, it is antecedent.

Usually a payment on an old debt--debt already owed at time Tx was made.

ii. A transfer is deemed to be "made" for 547(b) **<u>either</u>**: [547(e)(2)]

a. At the time such transfer takes effect (moment of delivery of property), **if** perfected at or w/in 30 days after transfer (RELATION BACK) [547(e)(2)(A)

(I) To determine when the transfer "**TAKES EFFECT**", go to UCC Article 9, Sec. 9203:

i.e., a transfer takes effect when attachment occurs

(1) A security interest attaches to collateral **when it becomes enforceable against the Dr with respect to the collateral**, unless an agreement expressly postpones the time of attachment.

(2) A security interest is enforceable against the Dr and 3rd parties with respect to the collateral only if [UCC 9203(b)]:

(i) Value has been given by C to Dr;

i.e., money loaned from Cr to Dr

(ii) Dr has rights in the collateral or the power to transfer rights in the collateral to a secured party; **AND**

*A Dr has "rights in goods" when the goods are identified [*UCC 2501].

(iii) **Either**:

(a) Dr has authenticated a security agreement that provides a description of the collateral and, if the security interest covers timber to be cut, a description of the land concerned; **or**

i.e., Dr has signed a security agreement

(b) The collateral is not a certificated security and is in the possession of the secured party under Section 9313 pursuant to the Dr's security agreement.

(II) To determine whether the transfer is "**PERFECTED**":

(a) Real property [547(e)(1)(A)]

(i) Perfection occurs as soon as a subsequent bona fide purchaser for value cannot acquire superior rights.

i.e., you can beat a BFP for V if you record properly under state law. So perfection occurs when the TD is recorded.

Some cases hold that inquiry notice will be perfection.

(b) Property other than real property (including interest in property) [547(e)(1)(B)]

(i) A transfer is perfected when a Cr on a simple contract cannot acquire a judicial lien that is superior to the interest of the transferee. [547(e)(1)(B)

(a) i.e., perfection occurs when you can beat a judicial lien Cr (JLC).

+ "*Line Cr*" [UCC 9102]

(ii) When can you beat a JLC? Go to UCC Article 9:

(a) A security interest is subordinate to the rights of a person that becomes a lien Cr before the earlier of the time the security interest is (state law) perfected. [Article 9 Sec. 9317(a)(2)]

(iii) When is a security interest state law perfected?

(a) A security interest is state law perfected if:

+ It has attached **and**

+ All of the applicable requirements for perfection have been satisfied

(i.e. once it has attached-->9203 and you have filed the UCC-1).

b. At the time the transfer is perfected, if perfected after 30 days (NO RELATION BACK) [547(e)(2)(B)]

4. The Dr must have been insolvent at the time of the transfer. [547(b)(3)]

i. Balance sheet test: Liabilities/debts exceed assets at FMV.

ii. If transfer is made 90 days w/in filing, then it is presumed that the Dr was insolvent. [547(f)]

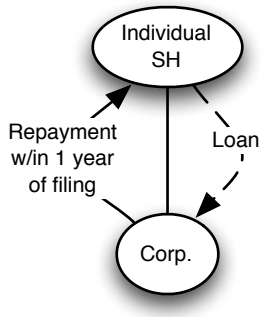
5. The transfer must have occurred w/in the prepetition avoidance period. [547(b)(4)]

i. 90 days before petition was filed; **or**

ii. 1 year before petition was filed if Cr = INSIDER.

EXA:

a.



(I) This payment will likely be deemed preferential.

(1) Rationale: Good chance insiders both know the corp is in trouble and are in control over payment.

b. "*Insider*" = Includes (i.e., some insiders aren't defined by statute) director, officer, person in control, partnership, etc. [101(31)(b)].

(I) Can also include suppliers who are very close w/Dr.

(1) "Non-statutory insiders"

6. The transfer must have improved the Cr's position. [547(b)(5)]

i. Did the transfer enable the Cr to receive more than it would have if:

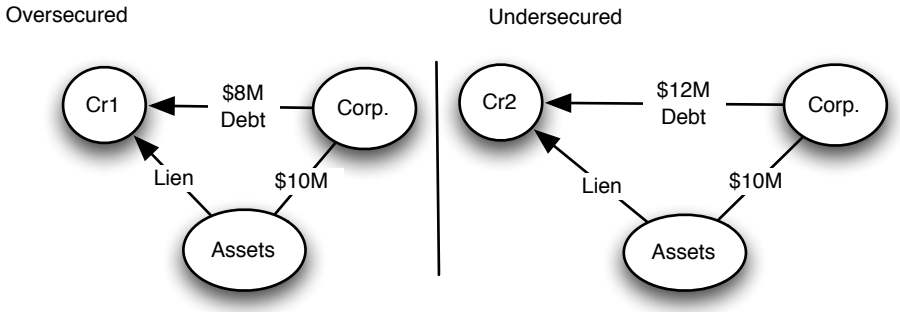
a. Case was filed under Ch. 7 Liquidation;

b. Transfer had not been made; **and**

c. Cr received payment of the debt to the extent provided by the provisions this title.

EXA:

ii.



a. Cr 1 will get paid in full in bankruptcy; Cr 2 is undersecured, so will not get paid in full.

(I) If Cr 1 gets a big payment from Dr right before bankruptcy, this payment does not make it any better off--it was getting paid in full anyway.

(1) Not getting something it otherwise wouldn't.

(II) If Cr 2 gets a big payment, it will be better off than it would have been in a Ch. 7.

D. Exceptions (Defenses) to Avoidance under Sec. 547(c)

Once the trustee has established that there was a preferential transfer under 547(b), the burden shifts to the transferee to establish that an exception applies.

1. Substantially Contemporaneous Exchange for New Value [547(c)(1)]

i. Trustee can't avoid a transfer **to the extent** the transfer was:

a. Intended by the Dr and the Cr to be a contemporaneous exchange for new value given to the Dr and

(1) Definition of "New Value" [547(a)(2)]

(i) **Money**, goods, services, new credit, release by a transferee of property previously transfered to transferee that is neither void/voidable by Dr (i.e., release of a valid lien), including proceeds of such property.

(a) Does not include an obligation substituted for an existing obligation

DOES THIS MEAN LIKE RENOGOTIATING AN EXISTING DEBT?

b. Was in fact a substantially contemporaneous exchange.

(1) No clear standard for "substantially contemporaneous--must argue both ways

2. Ordinary Course Payments [547(c)(2)]

i. Requirements

a. Payment was for a **debt** created by a Tx that was in the ordinary course of business or financial affairs of both the Dr and the transferee; **and**

i.e., incurrence of debt was in ordinary course.

b. Either:

(1) The **payment** of the debt was either in the ordinary course of business or financial affairs of the Dr and transferee **or**

i.e., payment was ordinary for the parties.

(2) The **payment** was made according to ordinary business terms.

i.e., payment was ordinary in the industry.

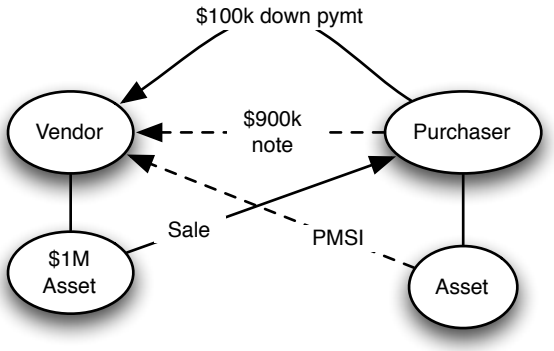
3. Purchase Money Security Interests (enabling loan exception)[547(c)(3)]

i. A PMSI = S/I granted by Dr to secure a loan or credit used to acquire the very collateral subject to the interest.

a. 2-party PMSI

(1) EXA: Cr sells $1M asset to Dr. Dr pays Cr $100k, gives $900k note, and grants Cr a S/I in the property.

(i)

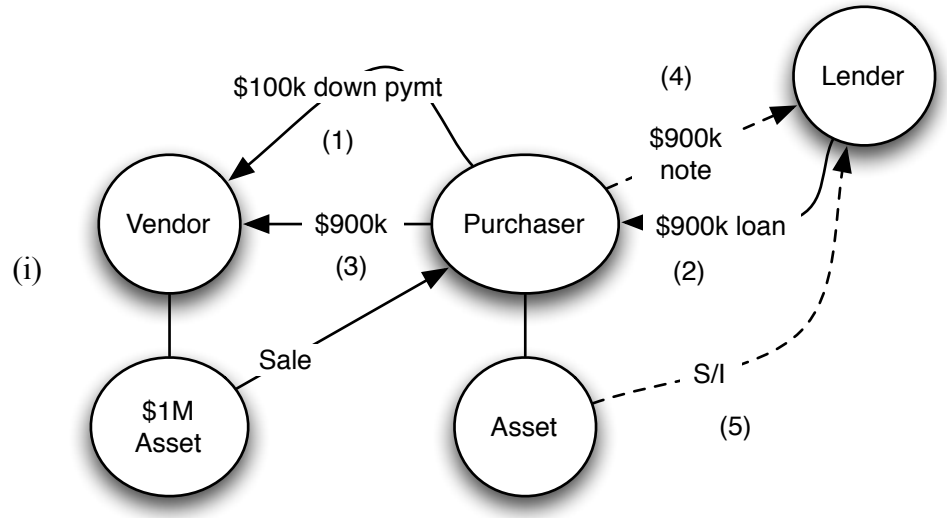


(a) This arrangement satisfies the requirements of 547(c)(3).

b. 3-party PMSI

(1) EXA: Dr buys equipment from seller, pays $100k cash down. Lender lends Dr $900k. Dr pays the $900k directly to seller. Dr grants lender $900k note and S/I in the equipment.

Typically this is all done simultaneously.



ii. Requirements

a. S/I secures **new value** that was [547(c)(3)(A)]:

"New Value" = money or money's worth [547(a)(2)].

(1) given at or after the signing of a security agreement that contains a description of the property as collateral;

(2) given by or on behalf of the secured party under the agreement;

(3) given to enable Dr to acquire the property; **and**

(4) in fact used by Dr to acquire the property

Make sure money is not commingled so that you can't tell that it was in fact used to acquire that property.

b. Perfected on or before 30 days after Dr receives possession of the property. [547(c)(3)(B)]

This is not the same as 547(e)(2)(A)--which requires attachment. Here perfection must occur win 30 days of Dr actually receiving the property.

RATIONALE: Holder of the interest has enabled the Dr to obtain the property that secures the debt.

iii. If not perfected w/in 30 days, then exception does not apply.

a. In that case, the transfer dates from the date of perfection according to 547(e)(3).

4. Subsequent Advance Rule (Net Result Exception--"Consolation Prize" rule) [547(c)(4)]

i. Situation

a. Cr receives a preference, but then gives something back to Dr/ships new goods to Dr.

(1) This defense = mitigation of liability.

ii. Requirements

a. The trustee may not avoid a transfer to or for the benefit of a Cr, **to the extent that**, after such transfer, such Cr **gave new value** to or for the benefit of the Dr that is:

(1) NOT secured by an otherwise unavoidable S/I; **and**

i.e., cannot off-set new value if it is secured by a valid S/I.

Rationale: If new value is validly secured, C will get payment even in bankruptcy; if C is allowed to also off-set preference liability, C gets double relief.

(2) On account of which new value the Dr did not make an otherwise unavoidable transfer to or for the benefit of the Cr.

(i) English: If, **after** receiving an **avoidable transfer**, the Cr gives to the Dr **new value** that is not itself secured or paid for by a new transfer, the otherwise avoidable transfer cannot be avoided **to the extent of the new value**.

If someone other than the Dr makes a payment for the new goods (e.g., Dr's president), it looks like the Cr will get paid for the value and will be able to use it as an off-set.

iii. Later-Honored Checks

a. Situation: Debt is incurred, check in payment of debt is delivered, but check is not honored until much later.

b. *Barnhill*: Transfer doesn't occur until check is honored for purposes of 547(b)--i.e., determining preference liability.

(1) However, for purposes of 547(c)(4), **date of delivery** controls

Policy: Otherwise, Crs will hold goods and not ship until check is honored.

5. Floating Liens in Inventory/Receivables [547(c)(5)]

i. Trigger

a. Increase in receivables or inventory, or the proceeds of either.

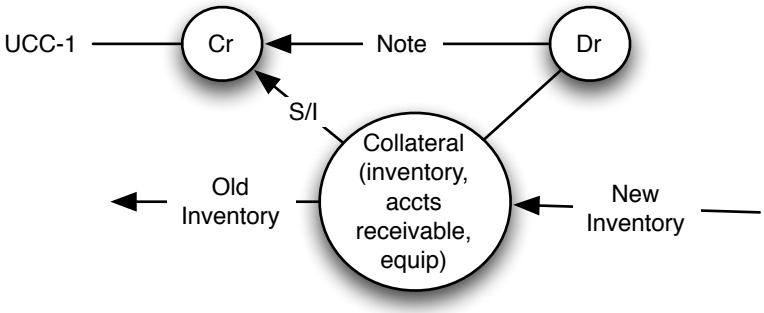
(1) Not triggered by an increase in equipment.

Rationale: Equipment does not turn over as frequently as receivables and inventory.

ii. Situation: S/I secures all advances made by the secured party (Cr) in the future and automatically attaches to all new collateral acquired by Dr in the future.

a.

b.



(1) As inventory is sold/accounts are paid, the loan is reduced by the proceeds.

(2) When a further batch of inventory is acquired/accounts are generated, the secured party will again make an advance in proportion to the value of the new collateral.

(i) Creates a stable relationship b/t debt and collateral.

c. These types of arrangements will almost always be governed by an **After Acquired Property Clause.**

(1) As new inventory comes into Dr's control, they automatically get added to the secured party's security package.

(2) These inevitably give rise to a preference problem w/respect to new property that comes in and gets covered by these clauses.

(3) But **a transfer is not made until the Dr has acquired rights in the property transferred.** [547(e)(3)].

iii. Rule: When a floating lien arrangement in accounts receivable or inventory has been validly created, each separate Tx in the 90 day period pre-filing does not have to be examined. The transfers to the secured party are **unavoidable** except **to the extent** that all transfers in the 90-day (1yr if secured party = insider) period **caused a reduction in the deficiency** to the prejudice of unsecured Crs in the estate.

a. "Deficiency" = amount by which the debt incurred exceeds the amount of the collateral.

(1) Extent of avoidance is enhanced by a lower value on the comparison date and a higher value on the bankruptcy date

(2) Extent of avoidance is reduced by a higher value on the comparison date and a lower value on the bankruptcy date

iv. Exception

a. If you can trace new equipment to the proceeds of inventory receivables, then there is no preference, b/c the new equipment is really disguised receivables.

(1) Tracing Proceeds in Anticipation of Bankruptcy

(i) Receivables and inventory Crs know that inventory/receivables will generate cash.

(a) If Dr buys equipment with those proceeds, it is not preferential--C needs to be able to prove this.

(ii) Situation: D generates inventory. Inventory is sold and creates accts receivable. The accts receivable is collected and turned into cash. Cr wants to establish a **lock box.**

(a) Bank acct over which C has control.

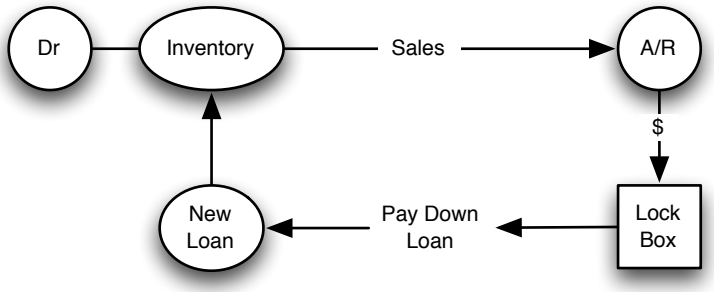
(b) C wants to perfect a S/I over that lock box to show it is C's collateral.

(c) Needs to trace the cash that goes into this lock box.

(d) When this cash is used to pay down the loan; C then issues new loan.

"REVOLVER"

(a)



+ Don't commingle.

v. Focus = overall improvement in position over prebankruptcy period, not specific, individual transfers.

a. If collateral was worth less than debt at the beginning of the period and transfers to transferee during the period had the effect of eliminating or reducing the deficiency as of the date of filing, then the transfers are avoidable to the extent that they made up the shortfall.

b. Transfers are not counted to the extent that they did not reduce the value of the estate to the prejudice of unsecured Crs.

vi. Analysis (two point test)

a. Determine First Date for Comparison

(1) Non-insider = 90 days before petition, or the date of the first advance if that occurred during the 90 day window

(2) Insider = 1 year

b. Determine the amount of the debt and the value of the collateral on this first date

(1) If secured party is undersecured (collateral worth less than debt), then calculate the deficiency.

c. Determine the amount of the debt and the value of the collateral on the date of filing.

(1) Calculate any deficiency.

d. Compare the deficiency on the two dates

(1) There is a voidable preference to the extent that the shortfall has been reduced, provided that the reduction has reduced the value of the estate to the prejudice of other Crs.

E. Issues

1. Exact same asset, but it increases in value in the period (e.g., oil).

i. Transfer must be **to the prejudice of other Crs.**

a. Some courts say that increase in value has to come from other Crs--if it comes from market forces, the increase is not to the prejudice of other Crs.

2. Manipulating the Two-Point Test

i. Can be done by putting pressure on a Gr to get corp to file on a certain date that will result in there being no decrease in deficiency.

3. *Increase and collateral and paydown of debt.*

i. If paydown is preferential, court will likely undo the paydown (so amount of debt goes up by same amount), and then evaluate any decrease in deficiency.

4. *Letters of Credit*

i. Irrevocable Standby Letter of Credit

a. Two types of Letters of Credit

(1) Documentary Letter of Credit

(i) Letter of payment entitling C to payment from issuing bank.

(a) C ships goods to Dr; as soon as goods are shipped, C goes to bank and has bank pay them immediately. Then bank gets payment from Dr.

(a) Here, there is no preference issue b/c money comes from bank directly.

(2) Standby Letter of Credit

(i) If Dr doesn't pay, then beneficiary (C) can draw on the standby letter of credit (i.e., issuing bank has to pay C).

Cr makes demand on bank only if C is not paid by Dr

(ii) As soon as the letter is issued, the primary obligor has an obligation to indemnify the secondarily liable party.

(iii) Issuing bank takes security interest in D's assets to secure the indemnity.

ii. *Powerine*: Dr incurs debt to C. Issuing bank makes an agreement w/Dr. Issuing bank will issue **irrevocable standby letter of credit** in favor of the C; this creates an indemnity obligation. There is a payment within the preference window. Letter of credit expires, and then Dr files bankruptcy. Trustee wants to avoid a $3.2M transfer. BAP says that there is no preference, b/c C was going to get paid either way (i.e., C was not made better off). *Held*, this money would not have come from Powerine--in a Ch. 7 proceeding, C would not have received $--the money from the letter of credit wouldn't go to C in a hypothetical liquidation. Therefore, the receipt of this money makes C better off than in a hypothetical Ch. 7. C argues that there is a 547(c)(1) defense--as the bank's claim against the Dr (reimbursement obligation) goes down, the bank's claim on the collateral goes down; if the letter of credit goes away, the indemnity obligation goes away, and so does the reimbursement obligation. The release of that lien constitutes a transfer of new value to the Dr (from issuing bank). Doesn't work, b/c bank was undersecured--so it didn't release its claim on collateral.

a.

III. FRAUDULENT TRANSFERS AND CUFTA

A. CUFTA

1. Allows unsecured Crs to avoid fraudulent transfers (state law).

i. Secured Crs don't need fraudulent transfer law, since their rights are already effective against subsequent transferees.

2. 544(b)(1) allows trustee to use CUFTA in bankruptcy proceeding.

3. Similar to 548, w/some differences (see chart comparison)

B. SOL

1. *Actual Fraud*

   i. **CUFTA** = 4 years; if longer than 4 years, then w/in 1 year after transfer should reasonably have been discovered; capped at 7 years max.

   ii. **548 = 2** years

2. *Constructive Fraud*

   i. **CUFTA** = 4 years

   ii. **548** = 2 years

C. Actual Fraud

1. *Rule*

   i. **A Cr can avoid an obligation incurred or a transfer made by the Dr with actual intent to hinder, delay or defraud any Cr of the Dr.** [CUFTA 4(a)(1)]

      a. Available to Crs whose claims existed at time of transfer and to those whose claims arose afterwards.

         (1) Rationale: All Crs should be able to respond to actual fraud.

2. *"Badges of Fraud"*

   i. Badges of fraud = inferences that help to prove actual fraud (i.e., NOT presumptions).

      a. Whether the transfer or obligation was **to an insider**;
      b. Whether the Dr **retained possession or control** of the property transferred after the transfer;
      c. Whether the transfer or obligation was **disclosed or concealed**;
      d. Whether before the transfer was made or obligation was incurred, the Dr had been **sued or threatened w/suit**;
      e. Whether the transfer was of **substantially all of Dr's assets**;
      f. Whether the **Dr absconded**;
      g. Whether the Dr **removed or concealed assets**;
      h. Whether the **value of the consideration received** by the Dr was **REV** of the asset transferred or the amount of obligation incurred;
      i. Whether Dr was **insolvent** or **became insolvent** shortly after the transfer was made or the obligation was incurred;
      j. Whether the transfer occurred **shortly before or shortly after a substantial debt was incurred**;
      k. Whether the Dr transferred the essential assets of the business to a lien-holder who transferred the assets to an insider of the Dr.

         The more badges you can establish, the more likely there is actual fraud.

D. Constructive Fraud

1. *Elements*

   i. Dr does not receive REV in exchange for transfer or obligation [CUFTA 4(a)(2)], **and either**

      Argue each of these in the alternative

      a. Subsequent or antecedent Cr and Dr was engaged or was about to engage in a business or a Tx for which the remaining assets of the Dr were unreasonably small in relation to the business or Tx (i.e., undercapitalization) [CUFTA 4(a)(2)(A)]; **or**

      b. Subsequent or antecedent Cr and Dr intended to incur, or believed or reasonably should have believed that he or she would incur debts beyond his or her ability to pay as they became due [CUFTA 4(a)(2)(B)]; **or**

         Section 4 constructive fraud: Antecedent or subsequent Cr + lack of REV + either unreasonably small assets/unreasonably small capital or debts beyond ability to pay (i.e., "cash flow crunch").

c. Antecedent Cr and Dr was insolvent at the time of the Tx or became insolvent as a result of the Tx. [CUFTA 5]

Section 5 constructive fraud: Antecedent Cr + insolvency + lack of REV

(1) Insolvency

(i) A Dr is insolvent if the sum of liabilities is greater than the sum of assets. [CUFTA 2(a)].

Balance sheet insolvency

(a) Measured at the time of transfer

(2) Rationale for only allowing antecedent Cr claim for CUFTA 5 actions = a Cr who extends credit to a Dr who is already insolvent should not get bailed out--that rewards irresponsible lending.

(3) As long as the Cr is the same and has a live claim against the Dr, this will be sufficient to establish antecedent Cr.

(i) EXA: C1 has claim in 2000 for goods XYZ. 2001 there is a FT to C2. 2002 Dr pays for XYZ. In 2003 Dr gets more goods from C1. C1 can serve as antecedent Cr.

2. Defining REV

i. Foreclosures are not FTs so long as there are no defects in procedure.

a. *BFP v. Resolution Trust Co.*: REV at a non-collusive foreclosure = fair and proper price for the foreclosed property, which is the price in fact received at the foreclosure sale, so long as all the requirements of the State's foreclosure law have been complied with. (In other words, REV does not necessarily mean FMV).

(1) Does not apply to **friendly foreclosure**

(i) i.e., where C forecloses and then sales to an insider/affiliate.

(a) Likely collusive foreclosure

(2) Does not protect **deed in lieu of foreclosure**

(i) Situation where Dr agrees to transfer title to C instead of going through foreclosure process.

(a) Will not qualify as regularly conducted foreclosure sell under *BFP*.

(b) If there are intervening liens, the deed in lieu may not preserve priority of C's title, so you may take title to the property where junior TD is bumped up to senior status.

E. Remedies for Fraudulent Transfers [section 7]

1. Two possible remedies:

i. Recovery of the property from the transferee so that it can be subjected to levy and sold in execution; **or**

ii. Money judgment against the transferee for the lesser of either the value of the property measured at the time of the transfer or the amount of the debt due by the Dr.

F. Liability of Transferee [550]

1. Trustee may recover the property transferred or (if court orders) the value of the property from either:

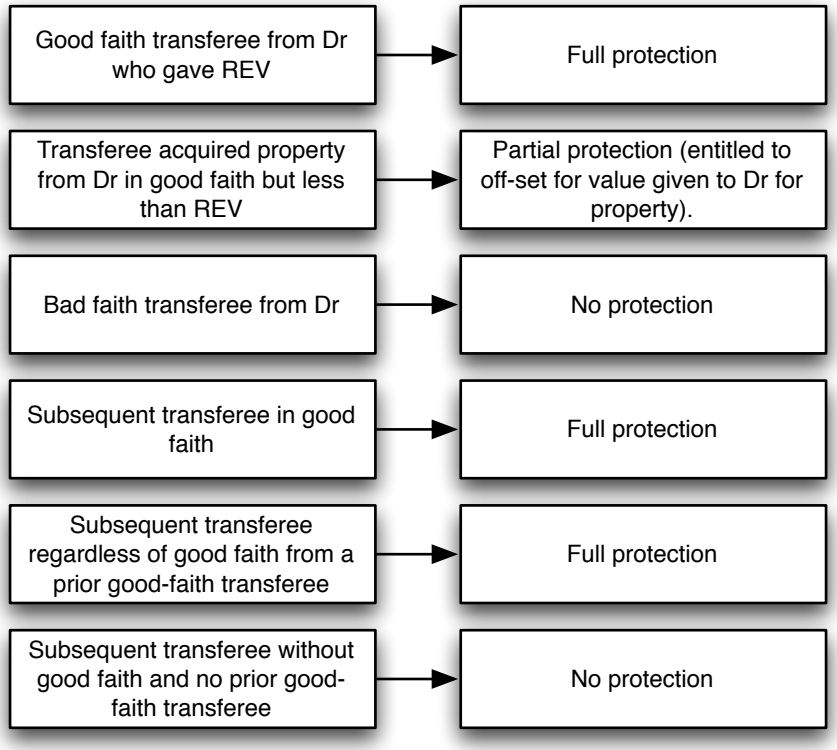
i. The initial transferee [550(a)(1)]; **or**

ii. Subsequent transferee [550(a)(2)]

a. **EXCEPTION:** Trustee **MAY NOT** recover from good faith (and w/o knowledge of prior transfer) subsequent transferee that is a BFP [550(b)(1)].

(1) This exception does not protect a 550(a)(1) defendant.

(i)



NOTE: 548(c) does not contain "knowledge" language. Courts have interpreted good-faith under both 548(c) and 550(b)(1) with an objective standard, but Shechter thinks this is an issue and doesn't know why this difference exists.

NOTE: LBO lenders are almost never found to be lending in good faith--they know what is going on.

2. *Determining the Identity of the Initial Transferee*

i. Not always easy to tell whether the defendant is an initial transferee or merely a conduit.
   a. EXA: Dr gives money to a messenger service, who delivers it to a 3rd party.
      (1) Messenger had no **dominion and control** over funds, so not an initial transferee.
   b. EXA: President of corporation has big gambling debt to casino. President gets cashier's check from Corp. and gives it to the casino. Casino will argue it is a subsequent transferee--money went to president first. So Casino claims they are entitled to good-faith defense.
      (1) If Casino either knew or should have known what was going on, then court may consider the president a conduit and strip the casino of the BFP defense.
         Analysis is result driven--no clear rule here.

G. Corporate Distributions as Fraudulent Transfers

1. *Determining Equity*

i. Assets - Liabilities = Equity
   a. "Equity" not necessarily = market capitalization.
      (1) i.e., equity does not = market capitalization

2. *Dividend distribution*

i. If corporation has retained earnings (profits), board can pay out profits to SHs in form of dividend distribution.
   a. If Corporation is insolvent, should not issue a dividend distribution--this money should be held for benefit of Crs, since SHs are only residual claimants.

ii. Illegal Dividend

a. Almost every state corp code prohibits dividend distribution while company is insolvent.
   (1) COA for improper distribution belongs to the corporation, not the Trustee
      (i) However, estate includes all of Dr's property as of the date of filing [541(a)(1)]
      (ii) So, if this claim exists when petition is filed, claim gets swept into estate and handled by Trustee.
         (a) i.e., Trustee does not have independent standing--only as successor in interest, but can prosecute this state-based SH derivative claim on behalf of estate.
         (b) Not an avoidance claim
   (2) *Robinson v. Wangemann*: A (president of Corp) sold 500 shares back to corp for $55k. Instead of cash, A received a note. At time notes were issued, corp could pay $, but issued notes instead. As time goes on, corp gets into trouble financially. Notes were rolled over (renewed) from time to time. Company files for bankruptcy, A wants to get paid on his notes. *Held*, A loses. **Purchase or redemption of shares confers no benefit on the company--corp can't vote its own shares, and can't give share of profits to itself--so when corp holds its own shares, the shares have no value. The retirement of shares benefits the other SHs, not the company itself.**
      (i) CA Rule: **The time of any distribution by purchase or redemption of shares shall be the date cash or property is transferred by the corporation, whether or not pursuant to a K of an earlier date.**
         (a) Exception: Does not apply where corporation purchases its shares by issuing to the seller a debt obligation that is an investment security of a type commmonly traded in the securities markets.
            (a) i.e., **bonds**, b/c bonds have a robust market and are designed to be sold/traded--not the case w/notes.
               Rationale: Bonds bounce around, so the end holder of the bond might not know that the bond was issued in connection with a share repurchase; whereas by looking at a note, the holder should be able to tell.

b. Savings Clause
   (1) Some notes contain provisions saying that the note is not payable if the payment would be illegal (i.e., corp is insolvent, or if the payment is a fraudulent transfer).
      (i) Trustee tries to invalidate the notes as fraudulent transfers.
      (ii) 7th Cir held that this was the incurrence of an obligation under 548(a)(1) despite the savings clause.

3. Remedies/Trustee's methods to attack a share redemption

i. Object to claim--SH's claim disallowed b/c not supported by consideration;
ii. Fraudulent transfer;
iii. Equitable subordination [see below]

4. Transactions for the Benefit of SHs

i. *In re Northern Merchandise, Inc.*: Corp w/3 main SHs. Corp tries to get a loan from Lender, gets rejected. Instead, Lender is willing to loan SHs $150k. In return, SHs give Lender a note which is collateralized by a S/I in the Corp's assets. $ was directly deposited in Corp. So now there is an obligation of the SHs collateralized by the Corp's assets. One of the SHs forms a separate entity, this new company takes assets of Corp. for chump change and NewCorp pays for SHs debt (almost certainly out of proceeds of those assets)--in other words, the issue is that corporate assets are being used to satisfy obligations of the insiders. Trustee's argument for FT is that at no point is the Corp getting REV. *Held*, there is REV--the $150k went directly into Corp. The money is either a loan or gift from SHs to Corp, so it makes a transfer to Lender in exchange for $ = REV.

a. Indirect Benefit Doctrine

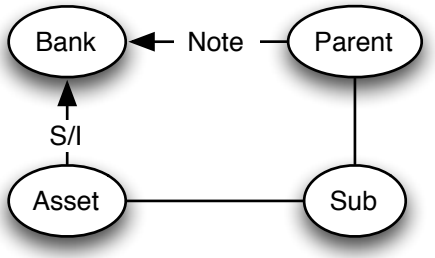
(1) If instead of getting direct benefit you get an indirect benefit, that indirect benefit can be taken into account when determining whether the Dr received REV.

b. Collapsed Transaction Doctrine

(1) Court takes a series of Tx and treats as one for purposes of determining whether Dr receives REV.

H. Cross-Corporate Guarantees

1. Basic Arrangement



i. Parent Corp, Bank, and Subsidiary. If Parent = real Dr, and Sub has assets and provides S/I on behalf of Parent, then there are three possibilities:

a. Sub = Dr/Co-borrower;

b. Sub = Gr

Problem w/this is that Sub hasn't issued a guarantee

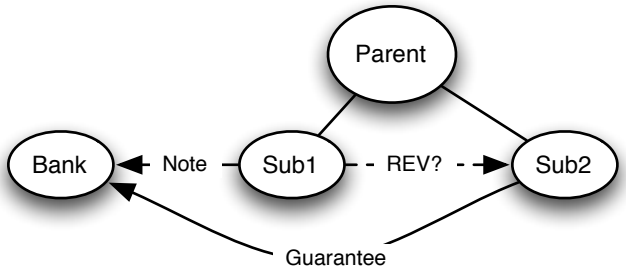
c. Non-recourse hypothecation.

(1) "Non-recourse" = bank can go after collateral, but not the Sub individually (b/c Sub hasn't provided guarantee)

(2) "Hypothecation" = mortgage/security interest where the only assets exposed are the ones specifically encumbered by the Cr.

Here, the sub, by lending its collateral, is at least supporting P's note/debt. So if P's debt goes away, the S/I goes away. Also, the granting of the S/I creates a form of an obligation in the sense that it encumbers that asset to the extent of the underlying debt.

ii. Other Problems w/Cross Corporate Guarantees



a. <u>Situation</u>: Parent, Sub1, Sub2, Bank. Sub1 issues a note to bank, Sub2 issues a guarantee, both in 2004. In 2007, there is bankruptcy. Sub's trustee attacks as FT. Bank argues that as of date documents were executed, everything was okay--no insolvency. In these situations, notes = **"revolvers."** I.e., new inventory is sold, generating A/R, generating money, pays down loan, new loan, etc. Courts have said that the guarantee is to be evaluated as of the date of the most recent draw (i.e., not date of execution), b/c each draw = new obligation.

(1) Problems:

(i) That renews the SOL;

(ii) Also changes the time as of when you evaluate the guarantee as an FT.

(a) Chances that there is insolvency at the later date is very high;

(b) The chance that the Gr Sub is getting REV is very low (b/c so close to bankruptcy, unlikely Sub2 will get some kind of synergistic REV).

(2) Solutions [CUFTA 6]

(i) An obligation is incurred if evidenced by writing, when the writing executed by the obligor is delivered to or for the benefit of the obligee. [CUFTA 6(e)(2)]

This is meant to solve the problem w/revovlers--i.e., date of execution matters, not date of most recent transfer.

(ii) HOWEVER, no such language is in 548.

(a) Some courts have said that Congress's failure to put the same language into 548 means that the renewal of the loan in a revolver = a new obligation, meaning that the trustee proceeding under 548 can invalidate all transfers w/in the 2 year period before bankruptcy regardless of the date of execution.

iii. Calculating the Solvency of the Gr

a. In order to calculate the effect of a guaranty on the solvency of the Gr, you look at the magnitude of the liability discounted by the risk of call.

(1) EXA: Sub1 = Assets of $10M, Liabilities of $9M, Equity of $1M. Sub2 = Assets of $6M, Liabilities of $4M, Equity of $2M. Sub2 guarantees $7M of Sub1's liabilities. On its face, this makes Sub2 insolvent, b/c liabilities now exceed assets. However, if there is a $7M value on the face of the guarantee, but only 10% chance of call, then the effect of the guarantee on the liabilities on Sub2 is only $700k (i.e., 10% of the guarantee).

Calculating the chance of call is basically a game of who can BS the best.

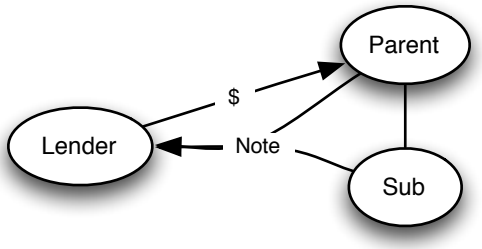
iv. ISSUE: When calculating the solvency of the Gr, do you look at each entity individually, or the entire corporate enterprise combined?

a. Majority of cases say individually for determining solvency--don't aggregate balance sheet.

(1) However, the balance sheets do have an effect on one another.

v. Problem: Part of Sub2's REV = possible remedies against Sub1. In many CA Txs, its possible to get waivers of Sub2's rights against Sub1 (CA property law--not bankruptcy law). However, those waivers then exacerbate the risk that there will be a lack of REV--**if no cross corporate rights, then most likely there is no REV at all.**

vi. Joint Borrowing Agreements

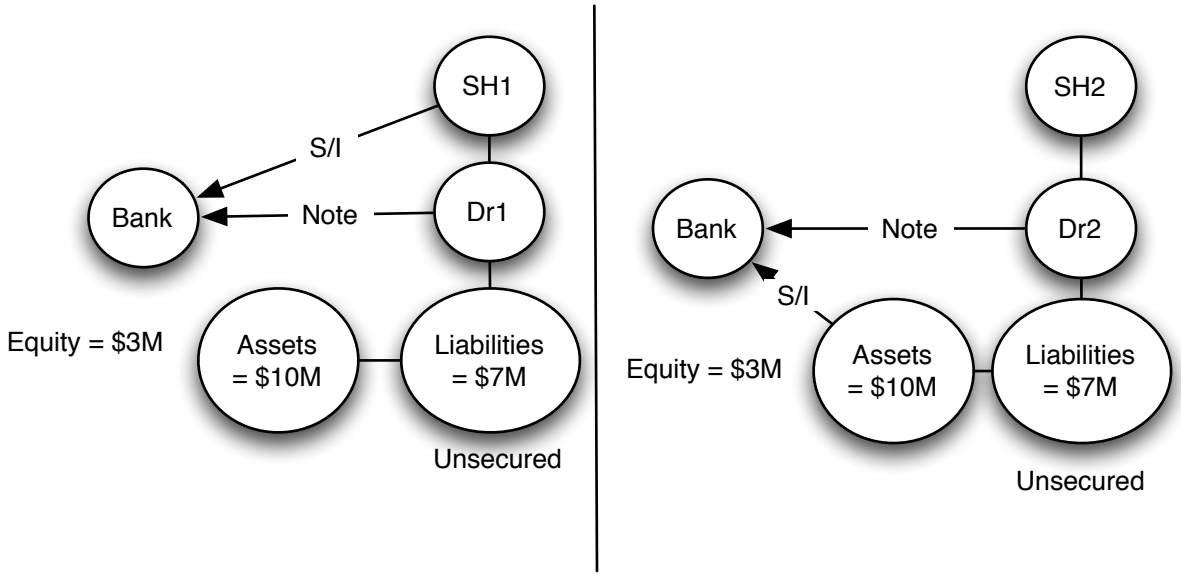


a. Parent and Sub jointly execute a note. Money gets deposited into their bank account jointly, and all $ goes to Parent--nothing to Sub. Sub's trustee goes after lender, saying note = FT and any collateral = FT b/c Sub got no REV. **Courts have held that the fact that the Lender wasn't aware of the rip-off, its too bad for them.**

(1) Initial transferee is strictly liable under 550(a)(1)--no BFP defense.

2. *Stock Pledge v. Asset Pledge*

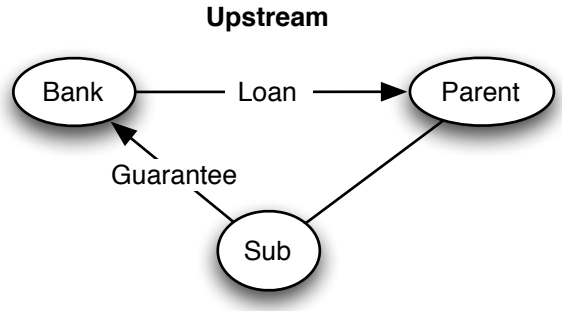
i.



a. Bank can only lend $3M to Dr1, b/c can only get $3M collateral in equity;
b. Bank can lend $10M to Dr2, b/c $10M collateral in assets.
   (1) Assets as collateral = better for Cr.

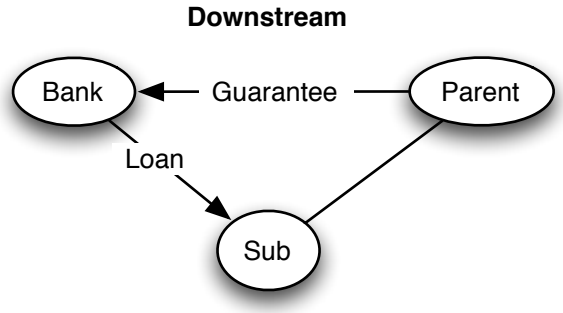
3. Upstream Guarantee v. Downstream Guarantee

i. Upstream Guarantee



a. Trustee will argue Sub is not receiving REV in exchange for its guarantee.
   i.e., the guarantee itself is a FT
   (1) Almost a per se fraudulent transfer
      (i) EXCEPTION: Must be able to show some kind of indirect benefit flowing to the Sub (as in *Northern Merchandise*)
b. Other arguments for relief
   (1) If the guarantee is invalid for being a FT, then the lien or S/I can be attacked as FT as well
      B/c if the guarantee is invalid, then the lien isn't securing anything, so it is invalid as well. When you grant a lien to someone, there has to be a debt/obligation to which the lien corresponds--lien can only secure an underlying obligation.
   (2) If the lien is invalid, and the sub has made some payments on the guarantee, the payments are attackable as FT as well
      EXAMP TIP: On exam, look for not only a FT w/respect to the guarantee, but look for FT w/ respect to the S/I and any payment made on the invalidated guarantee (i.e., 3 attacks)

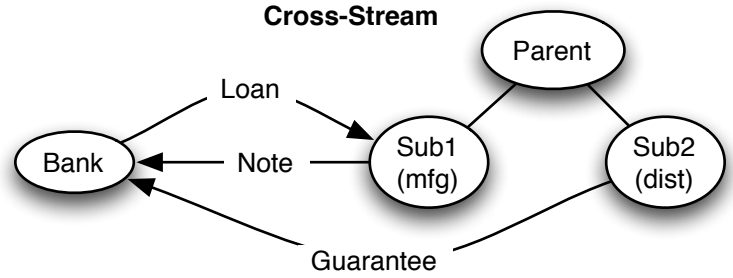
ii. Downstream Guarantee



a. Here, money is going to Sub, but Parent = SH of Sub, so getting some sort of benefit.
   (1) Very hard to attack as fraudulent transfer b/c Parent is getting some benefit in exchange for the guarantee.
      (i) EXCEPTION: Where the Sub is about to die (and there is no hope of a benefit flowing back to Parent), this may be a fraudulent transfer. ("Black hole" cases--guarantee is a joke, not supported by REV).

iii. Cross Stream Guarantee

a.



   (1) Here REV is subtle.
   (2) Bank should get a fairness opinion proving existence of REV.

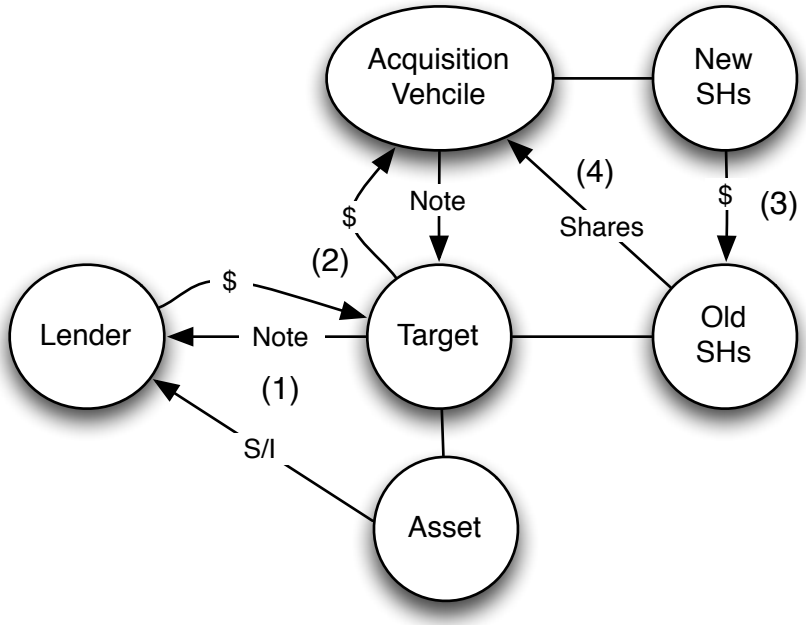
Insolvency of Sub2 at time guaranty is issued will be determined by calculating the magnitude of the risk x the chance of call.

I. LBOs

1. Definition of LBO

i. Tx in which the purchase of shares in a corporation is financed by the corporation itself or secured by the assts of the corporation.
   a. Expectation is that reimbursement of the corp will come from future profits.

2. *Typical Structure*

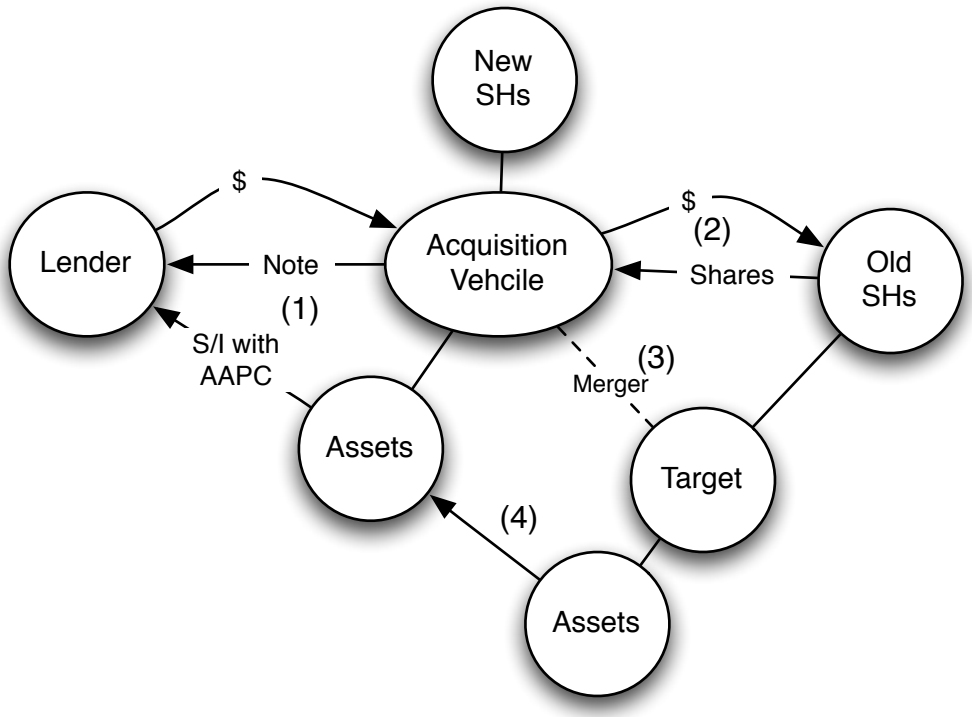


i. T has assets and Old SHs. New SHs want to acquire the company. New SHs form an acquisition vehicle. Lender provides cash to T in exchange for a note and a S/I on T's assets. T loans the money to the acquisition vehicle, and the acquisition vehicle gives T a note in exchange for the cash. Acquisition vehicle gives the money to the Old SHs, and the Old SHs give their shares to the acquisition vehicle. Then T and acquisition vehicle merge. Looks like series of arms-length Txs. At the end of the day, there is the merged entity w/new SHs and the Lender holding the note and S/I. After dust settles, company now has huge debt load--so insolvent on balance sheet basis, and must service the debt.

Schechter thinks the TCs are getting ripped off here.

a. Prima facie FT.

3. *Alternative Structure*

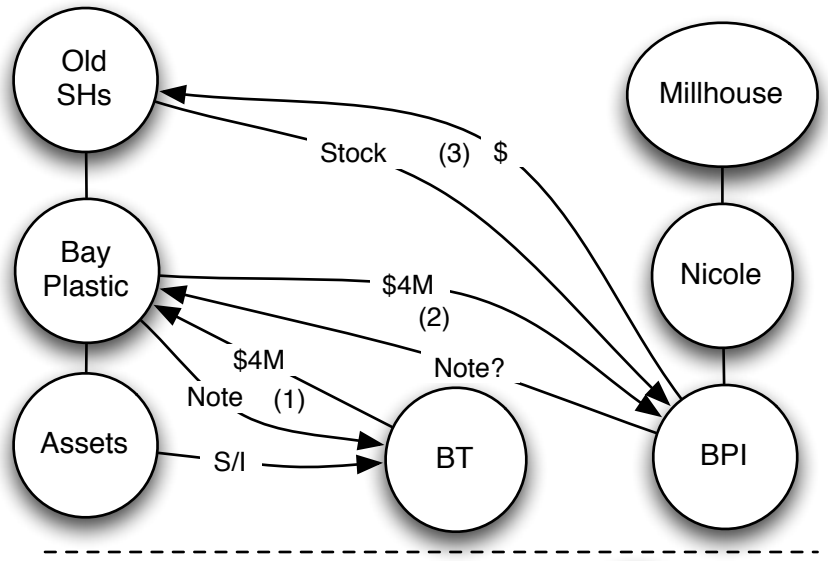


i. New SHs want to acquire T, form AV. AV grants Lender a note and S/I w/AAPC in its assets (which at this point are empty) in exchange for cash. AV gives that cash to Old SHs in exchange for shares. AV and T merger. T's assets get rolled over into AV's assets by AAPC, so the S/I covers those assets now.

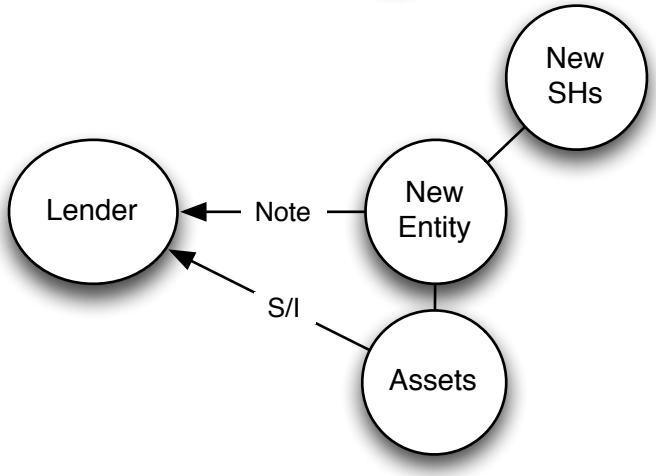
Same outcome as typical structure--don't be fooled into thinking this is any "better."

4. *Bay Plastics*: Millhouse creates Sub (Nicole), which forms BPI. Bay Plastics has Old SHs. BT = bank. BT gives Bay Plastics $4M in exchange for S/I in assets. Bay Plastics then gives the $4M to BPI in exchange for a note or some type of intercorporate guaranty. BPI gives the cash to the Old Bay Plastic SHs, gets stock in return. In the end, Millhouse owns the assets of Bay, and BT holds a note and S/I on the assets. When dust settles, New Entity w/New SHs owns old Bay Plastics assets; Bank has note from New Entity and S/I in assets. Prior to LBO, Shintech was supplier to Bay Plastics. Shintech agreed to release their S/I; told it was a merger, but not told it was an LBO--so ends up as an unsecured Cr of an insolvent entity (where it was before a secured Cr of a solvent entity). This Tx left the company insolvent, if it were not for "good will" that was included on the asset part of the balance sheet--but "good will" has no liquidation value.

(1)



(2)



5. *Other Possible Issues*

i. Aiding and Abetting Breach of Fiduciary Duty

a. In an upstream FT type situation/LBOs, Lender works hand in hand w/Dr's SHs. Those SHs may be liable for breach of duty (depending on facts). In FT action, Trustee should go after Lender for aiding and abetting breach of fiduciary duty.

(1) Clean Hands Defense

(i) Lender may argue that Dr can't bring this COA b/c it was the one doing the FT in the first place.

Schechter thinks this is BS--b/c pre-bankruptcy company has no say in the matter--slave to the Old SHs.

6. *Remedies Against Old/New SHs*

i. Old SHs

a. They receive cash--so you want to recover that cash.

(1) Problem: 546(e)

(i) Exception to 547/548: Trustee can't avoid a settlement payment made by/to a financial brokerage or by/on behalf one of these.

Might still have tort liability, but no FT liability.

(a) Usually the share repurchase is handled w/intermediate stock brokerage--so if the old SHs do this right they can protect themselves from fraudulent transfer liability.

(a) Anything characterizable as a settlement payment can't be subject to FT.

(b) As long as there is a broker is in the middle, 546(e) shelters the old SHs.

(2) Situation: Trustee brings breach of fiduciary duty claim against insiders. Insiders are insured by a D&O carrier. Insiders will settle w/Mary Carter agreement; usually, the D&O carrier won't provide the coverage/won't settle. So insiders now have a bad-faith claim against the carrier. Trustee can take an assignment of that bad faith claim on behalf of the Dr.

7. *Junk Bonds*

i. Smart lender will use conservative loan-value ration (60%-70%).

ii. To make up deficiency w/additional funding, the acquisition vehicle will float bonds (unsecured corporate obligation)--subordinated notes.

a. Holders = subdebt

iii. If LBO crashes, Trustee can sue either the lender or the subdebt.

a. Estate gets nothing in return for bonds

(1) Money goes straight to the old SHs (this applies to all LBO financing).

(i) If any payments on bonds is made, again estate gets nothing.

(a) But if a company sells bonds for ordinary operations (buying equipment etc), i.e. not in relation to an LBO, then no FT.

J. Unsolved Mysteries of FT Law

1. *548(a)(1)(B)(ii)(III) v. CUFTA 4(a)(2)(B)*

i. "Intended or believed" v. "Intended, or believed, or reasonably should have believed"

a. Looks like CUFTA incorporates objective standard, but 548 is just subjective.

(1) No evidence in case law for this distinction.

(2) Schechter's argument: Recipient of funds should argue that there is a real linguistic difference, so Congress doesn't intend an objective standard by in 548(a)(1)(B)(ii)(III).

Implication if successful: Tranfseree prevents avoidance of transfer.

2. *Value of Avoided Transfer: Time of Transfer or Time of Action--CUFTA 8(c) v. 550(a)*

i. "Value at the time of transfer" v. 550(a) is silent re: valuation date.

a. HYPO: FT of house in 2001 to defendant (worth $1M). Dr goes bankrupt in 2004 (house worth $2M). Prosecution in 2007 (house worth $4M): Trustee v. defendant. Issue is how much is the Trustee entitled to?

(1) 550(a) has preamble saying "to the extent that a transfer is avoided under section 544..."; 544 = CUFTA, so valuation is limited to value at time of transfer.

(i) But courts are split.

3. *Can Estate Sell Causes of Action to Buyers?*

i. 9th Cir. says yes--estate can sell COA's to highest bidder.
   a. Bidder can then prosecute the claim and keep proceeds.
      (1) Needs to have a backend kicker going to estate so that the prosecution qualifies as being "for the benefit of the estate" under 550.
   b. Almost never done
      (1) Uncertainty re: value of the COA
      (2) Defendant will likely be the buyer, b/c they know how much it is worth.
         (i) Possible to have a potential buyer serve as a stalking horse to prompt defendant to come in and over bid.
         (ii) Stalking horse then gets some sort of stalking horse fee.
ii. Sometimes estate can make a deal directly with the defendant.
   a. But courts don't like this, b/c its basically a settlement

K. Leveraged Recapitalization

1. Situation: SH1 and SH2 each own 50% of Corp. SH1 wants to cash out. Lender lends money to Dr, which goes to repurchase shares from SH1; Lender takes back a note and a S/I in assets in exchange for this. At the end of the day, SH2=100% owner.
   i. FT b/c money is being upstreamed to SH1; no REV b/c shares have no value in the hands of the corp according to *Robinson v. Wangeman.*

L. Refinanced LBO

1. Situation: LBO in 2000. In 2004 it is refinanced--replace old LBO paper w/new LBO paper. In 2007 there is bankruptcy.
   i. Trustee will argue that the original LBO was an avoidable FT, but SOL has passed. But when it was refinanced, Dr didn't get anything new--unenforceable obligation was rolled over into a new obligation without any REV going to Dr.
      a. Probably won't fly.

M. Leveraged Asset Acquisitions

1. Situation: Old SHs, Old Corp., Old Corp. assets. New Corp., New Corp. assets. New Corp gets money from Lender. New Corp transmits money to Old Corp. for the assets. Money gets immediately upstreamed to Old SHs. There are old trade Crs who get left out in the cold.
   i. Some cases hold that the participants are FT transferees--no REV b/c it went upstream. So everything gets unwound.

IV. STRONG ARM STATUTE - 544

A. Issue Trigger:

1. Dr has assets; C holds a secret lien on those assets (i.e., an **unrecorded lien**). Trade Crs extend credit to Dr, only seeing Dr's assets (not the lien), which seem unencumbered. No way for the trade Crs to see the assets are encumbered, so they are misled.

B. What it Does [544(a)]

1. Discourage secret liens and protect reliance interest of trade Crs.

2. Gives trustee, **w/o regard to any knowledge of trustee** or any other Cr, the rights and powers of, or **may avoid any transfer of property** of the Dr **or any obligation incurred** by the Dr that is voidable by:
   i.e. Trustee has standing to destroy secret liens for the benefit of unsecured trade Crs if the lien can be beat by the following:
   i. Judicial lien-holder for non-real property (even if hypothetical) [544(a)(1)];

a. Judicial lien = *a lien arising out of judgment, levy, or some other judicial process* [101(36)]

JLC status is not sufficient to give trustee power to defeat a transfer of RP; this is why we need 544(a)(3).

(1) i.e., can avoid unperfected Article 9 Txs

UCC 9317

ii. Unsatisfied execution Cr [544(a)(2)];

Don't need to worry about this one

iii. BFP of RP (even if hypothetical) [544(a)(3)]

a. Trustee is deemed a perfected BFP of RP who records as of the date of the petition.

(1) If such a BFP would take precedence over the pre-existing interest in the RP, the trustee can avoid the Dr's transfer of that interest.

(2) Trustee cannot establish BFP standing if there is inquiry notice.

(i) *McCannon*: M bought hotel from Dr. M did not record. Dr files bankruptcy. Trustee tries to avoid. *Held*, there is a difference b/t "knowledge" and "notice"; M was living wide open-this would put a subsequent BFP on inquiry notice. Any subsequent BFP would have asked whether M claimed an ownership interest.

(ii) Some Case: Petition is filed and mentions lien. Court deems this as perfecting the Tx, so Trustee can't win on 544(a)(3). Solution: Re-file a 547 claim arguing delayed perfection = preferential transfer.

3. Trustee attains these statuses as a matter of law--not dependent on there being an actual party in such a position.

NEED TO KNOW 544(B) -- E&E P. 335*337?

C. Hermit Crab Rule: Automatic Preservation of Avoided Transfer [551]

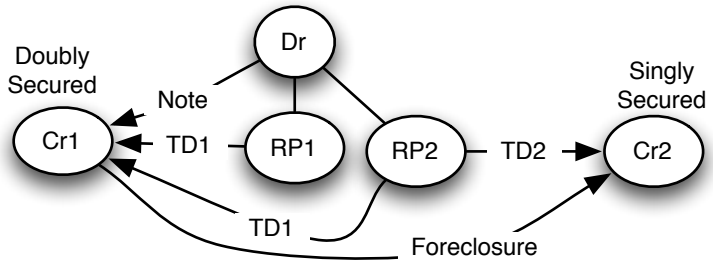
1. Any transfer avoided under 544, 547, 548 etc., is preserved for the benefit of the estate, but only w/respect to property of the estate.
   i. This means that junior Crs won't necessarily receive a bump in priority.
   ii. If the junior lienholder is not aware of the senior lienhonlder, the junior lienholder can move into a senior position.
      a. If it is a secret lien, then the subsequent lien-holder may have the power to move into a senior position.
      b. However, junior Cr will remain junior to trustee if, in absence of bankruptcy, junior Cr would still be junior (i.e., if junior Cr is NOT a BFP for value).

What does it mean? Does Trustee get to recover the extent of security held by the senior?

2. Marshaling Doctrine

Situation:

i.

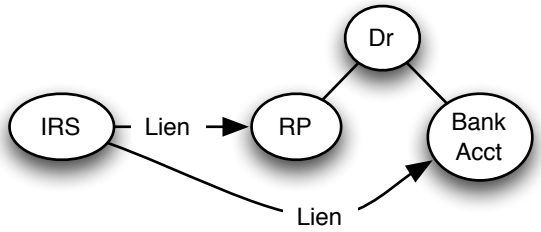


a. Dr w/2 pieces of real property, RP1 and RP2. C1 holds Dr's note which is secured by TD1 on RP1 and RP2. C2 has junior lien on RP2. Cr1 = doubly funded/doubly secured, Cr2 = singly funded/singly secured. Cr1 seeks foreclosure against RP2. Cr2 is not happy--wants Cr1 to go after RP1 first so as not to impair Cr2's rights, since RP1 is singly encumbered.

(1) Junior Cr can compel the senior Cr to foreclose on singly encumbered property before reaching the doubly encumbered property to the prejudice of the junior. (This is Marshaling-equitable rule in states).

Situation 2:

ii.



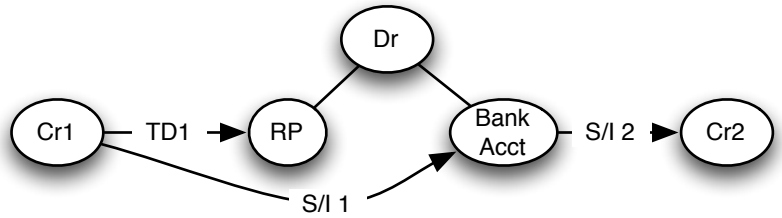
a. Dr has RP and bank account. IRS has tax lien on RP and tax lien on bank acct. Dr goes bankrupt. IRS wants to grab the cash in the acct. RP is not reachable by trustee for some reason (homestead exemption), but is reachable by IRS. Trustee objects to IRS attempt to reach bank acct. Argument: 544(a)(1) makes trustee hypothetical JLC, so trustee has judicial lien on the bank acct. Therefore, as a junior lien Cr, trustee can tell IRS to go after RP first, then come after cash. Court agrees w/trustee.

(1) Majority view = trustee can be viewed as JLC in this situation and can invoke marshaling.

(i) i.e., Trustee can compel IRS to go after RP first before going after the cash.

iii. Situation 3 - Exception:

a.



(1) Dr w/RP and bank acct. CR1 has TD1 on RP and lien on bank acct. CR2 has S/I on cash. Trustee comes in has hypothetical JLC. Issue: Can the trustee use his status as a hypothetical Cr to block marshaling, b/c if CR2 arises before bankruptcy and the trustee's arises on the date of bankruptcy, its as if the trustee is in a 3rd priority position. Since trustee is JLC, can he invoke his status as a Cr to block CR2's use of marshaling.

(i) If there were a legit 3rd lien holder, CR2 would be prohibited from invoking marshaling to the detriment of that 3rd lien holder.

Does this mean that yes, trustee can block?

D. Property of the Estate

1. *Legal v. Equitable Title* [541(d)]

i. Rule

a. If Dr holds only legal title and not an equitable interest at the time a petition is filed, the property becomes property of the estate under 541(a)(1) or (2) only to the extent of Dr's legal title to such property.

b. HOWEVER, 541(a)(3) brings into the estate anything recovered by the Trustee through 550 etc; i.e., any recovery under 547, 548, and 544(a)(&(b).

(1) Therefore, to the extent Trustee brings in property under 550, he brings it in under 541(a)(3), and so the recovery is not limited by 541(d).

(i) Possible Glitch: If it is a mere avoidance action (and not an action for recovery), then Trustee does not need to invoke 550--only has to invoke 544(a)(3) to invoke BFP status. In that case, the defendant could argue that b/c 550 isn't pled, then 541(a)(3) does not apply, so 541(d) does apply.

ii. Property Held by Dr as Nominee/Trustee

a. *Belisle v. Plunkett*: RP. WOF is T1 w/50 year lease. Dr obtains an assignment of the lease (i.e., Dr = assignee of lease). Lease is recorded in Dr's name, but it is really on behalf of a group of investors. D borrowed money from a bank personally, and executed a note and mortgage (leasehold deed of trust--LDT) which is security for his debt. P files bankruptcy, Trustee wants to recover on lease. The partnerships argue that the leasehold really belongs to them, not P. Partnership argues there is a

distinction b/t legal and equitable title. Trustee argues that P conveys his interest to the Partnership, but this is unrecorded; under 544(a)(3) Trustee is a BFP and so can divest the Partnership of its interest. But Partnership argues that 551(d) trumps this. However, see above for the discussion re: 541(a)(3) (but the glitch thing doesn't apply).

(1) Bottom Line: If its an avoidance, then the property comes into the estate even if Dr only has legal (but not equitable) title.

iii. Trustee Trying to Get Property in Estate under 541(a)(1)&(2)

a. **Situation**: Bank 1 and Bank 2. Bank 1 has notes/mortgages. Wants to transfer (sell, etc) them to Bank 2. This will be an assignment. However, often this assignment isn't recorded; if unrecorded, then it is a transfer of an interest in RP (the mortgage), is unrecorded. This will be a 544(a)(3) problem.

b. Usually this is not the situation: Usually, there is a group of notes and a group of mortgages. Bank 1 wants to sell them to Bank 2. At the same time, there is a recourse obligation where Bank 1 is obligated to make Bank 2 whole if the notes/mortgages aren't paid in full when due. This looks like an obligation of Bank 1 secured by the bundle of paper--which is actually personal property (a bundle of assets used as security).

(1) So if not documented properly, then 541(d) will not apply, b/c it won't be a secondary market Tx, but rather a S/I secured by a personal obligation, meaning 544(a)(1) or (3) will apply--so property will come into estate under 541(a)(3) instead of (1) or (2) (i.e., *Belisle* outcome will result)

V. EQUITABLE SUBORDINATION

A. What it Does

1. The court may

i. Subordinate for purposes of distribution **all or part** of an allowed claim to **all or part** of another allowed claim or **all or part** of an allowed interest to **all or part** of another allowed interest [510(c)(1)]; **or**

ii. Order that any lien securing such a subordinated claim be transferred to the estate. [510(c)(2)]

B. Extent of Subordination

1. A claim i subordinated only to the extent necessary to rectify the harm/prejudice

C. General elements

1. Inequitable/dishonest (wrongful) conduct

i. Fraud, illegality, breach of fiduciary duties;

ii. Undercapitalization;

iii. Claimants use of the Dr as a mere instrumentality/alter ego

But some courts will subordinate claims of innocent Crs if equitable considerations of the case require(this is controversial).

2. Prejudice to other Crs

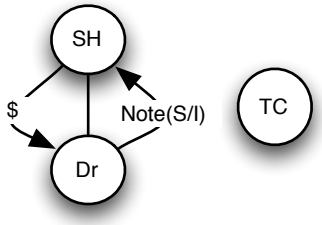
D. Equitable Subordination of Insider Claims

1. Insiders = Crs, not SHs

i. SHs are always subordinate to Crs b/c they are residual claimants.

2. SHs as Crs

i. EXA: SH makes loan to Dr pre-petition, takes back note and maybe S/I. Once bankruptcy happens and there are TCs w/claims against the estate, is the SH's note treated on par w/TC?



ii. Court will subordinate the claim if the Dr was undercapitalized from its inception

a. Tests

(1) A Dr is undercapitalized if its funds would definitely be insufficient to support a business of the size/nature of the Dr in light of the circumstances at the time Dr was capitalized;

(2) A Dr is undercapitalized if, when the advances were made, the Dr could not have borrowed a similar amount of money from an informed outside source.

(i) Court will look at whether a bank would have made the same loan (usually not, or else corp would have gone to bank).

(a) Public Policy: TCs are outsiders and don't know company is going down, but insiders do.

(b) Could possibly be a fraudulent transfer.

3. Recharacterization as of Debt as Equity

i. Not really equitable subordination.

ii. Where an insider provides funds to the Dr structured as a loan, a court can use its equitable power to declare the Tx as creating equity, not debt.

a. The lender is therefore removed from the ranks of a Cr and treated like an owner (i.e., residual claimant).

E. Non-insider Crs

1. Situation: C starts to exert control over Dr so much that it has control over the affairs of the insider

i. If the outside lender/Cr becomes too involved in day to day affairs of Dr, Cr may be considered an insider.

ii. Agency Argument

a. Argue that b/c C took control, Dr was really acting as agent of C (i.e., Cr = principle); so all liabilities of Dr are really liabilities of C.

(1) Kind of like piercing corporate veil;

(2) Rarely successful but leads to good settlements.

iii. Fiduciary Argument

a. Argue that if a bank takes control, it is exposed to fiduciary liability.

(1) Almost never held, but leads to good settlement.

F. Remedies

1. Absolute Subordination

i. Cr is pushed to back of line.

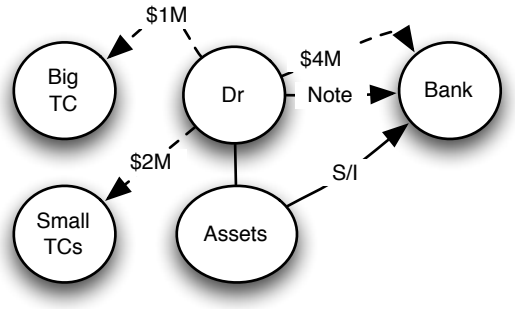
a. But not always appropriate.

2. Partial Subordination

i. Cr is subordinated only to the extent that is equitable.

a. EXA:Dr, big TC, bunch of little TCs. Dr has note in favor of bank. Bank has S/I on assets. Bank realizes it is under-collateralized and is worried about short-fall. Big TC calls bank and asks about Dr;

bank says Dr is doing good and to keep shipping. Dr owes Big TC $1M; little TCs $2M; bank $4M. Courts have subordinated the bank only w/respect to Big TC.



(1) Problem: **Ripple Reliance** (not a winner yet)

(i) Little TCs often follow lead of big TC, so they get harmed too.

(a) Not yet a successful argument to subordinate Cr below small TCs.

G. Consensual Subordination

1. A senior claimant may agree to subordinate its claim to induce another person to enter into a desirable Tx w/Dr. [510(a)].

English: Subordination agreements are enforceable.

i. But 510(c) (involuntary subordination) likely trumps 510(a).

a. EXA: Dr, C1, C2. C1 and C2 enter into subordination agreement in which they switch places. Why would C1 swap places? Very often, C1 is a big ordinary bank that has lended a lot of money and can't lend any more, C2=rescue lender. So C1 will agree to subordinate itself in favor of C2 b/c C1 wants the cash to come in. But now suppose C2 does bad things to D (control, loot assets etc). C2 will likely be subordinate to C1 despite the agreement.

2. *Turnover Agreements*

i. Provision inserted into a consensual subordination agreement.

a. Says that if C1 subordinates itself to C2. Turnover agreement will require C1 to hold any money it receives in bankruptcy in trust for C2 if the court equitably subordinates C2 for bad conduct.

(1) Effectively undoes 510(c)'s trumping of 510(a).

(i) K issue, not bankruptcy.

(ii) So after bankruptcy, C2 will go to state court to try to enforce the agreement.

(a) Some state courts have enforced these clauses.

(a) But raises question of res judicata.

H. Substantive Consolidation: Multiple Drs

1. Under this doctrine, the assets of several Drs, usually affiliated corps in a family of corps operated as a unit, are pooled in bankruptcy and the claims of Crs of any member of the corporate family are treated as claims against the consolidated assets of all members of the family.

i. Shared bank accounts, Crs, employees, etc (i.e., parent/sub corps)

a. **Problem**: Separate lenders w/separate liens on the assets of those multiple Drs.

(1) Makes prioritization of claims difficult.

(i) However, where there are valid, conflicting claims of multiple Crs, there will not be substantive consolidation.

(ii) Otherwise, if the entities have different assets and different solvencies, you will likely dilute somebody's claim.

2. Inter-corporate Accounts Receivables

i. Situation: Dr1 and Dr2, with intercorporate accounts receivable. If we consolidate these two entities into one estate, the receivables go away--its like a merger. So if you're interested in a company that has a net surplus on those receivables, its not a good idea to blend those companies.
   a. Can also have a fraudulent transfer w/respect to one estate but not the other; blurring the companies into one will make those FT claims disappear.
      (1) But defendant in an FT action will want court to substantively consolidate in an attempt to make these causes of action disappear.

VI. AUTOMATIC STAY

A. Prohibition of Actions Once Petition is Filed

1. Bankruptcy petition operates as a stay of the following, applicable to everyone [362(a)]:

   i. A proceeding against the Dr that could have been commenced before the petition, or to recover a claim against the Dr that arose before the petition [362(a)(1)];
      a. However, if you have a lawsuit pending against the Dr, you don't necessarily have to dismiss, but you do have to notify the court immediately that the petition has been filed.
         (1) All proceedings will be stayed unless bankruptcy court gives the green light.
      b. Foreclosure on RP
         (1) EXA: Dr, piece of real property. Non-judicial foreclosure. Trustee (not bankruptcy trustee) holds auction; sells property to purchaser. Shortly after sell, Dr files bankruptcy petition. But trustee hasn't yet issued a deed to purchaser. New statute says: **If trustee issues deed w/in 15 days of date of foreclosure, then deed is deemed issued as of 8:00am on the date that the foreclosure occurred--so deed relates back to foreclosure.**
            So issuance of the deed doesn't violate the automatic stay.
            (i) Sometimes foreclosure trustee doesn't want to issue it; however, purchaser can put a clause in the sale K requiring the foreclosure trustee to issue the deed in the specified period.

2. *What Stays Can/Can't Reach*

   i. 3rd Party Stays
      a. **Situation**: Gr = SH running Dr, which is a DIP. Bank can't go against Dr b/c of stay, so bank wants to go against Gr. But Gr is critical to the running of Dr.
         (1) Bank will argue 524(e), which says that discharge of debt of Dr does not affect the liability of any other entity on, or the property of any other entity for, such debt.
            (i) But court can protect Gr to protect the affairs of the DIP
               (a) 105 allows the bankruptcy court to do this (wildcard section--basically allows bankruptcy court to do what it wants).
                  JDX SPLIT

3. *Insurance Companies*

   i. Issue: Two what extent does a stay affect an ins. co. that has issued a policy in favor of Dr?
      a. If the policy and its proceeds are indirectly assets of the estate, shouldn't the stay protect the insurance co as well?
         JDX SPLIT

B. Exceptions [362(b)]

DON'T NEED TO KNOW THESE

C. Termination of the Stay [362(c)]

NEED TO KNOW THIS?

D. Relief from Stay [362(d)]

1. **Situation**: Just about to go to judgment in state case, but Dr files bankruptcy. In this situation, it makes no sense to put the whole trial on pause and go litigate in bankruptcy court, so relief may be granted.
   i. Bankruptcy court may permit you to get through to judgment, but judgment cannot generally be executed on;
   ii. Court may preserve for itself a chance to take a shot at the judgment.
      a. Bottom Line: Don't count on finality of judgment or ability to collect judgment.
2. *Justifications for Providing Relief*

i. For cause [362(d)(1)]

a. Cause = "Lack of adequate protection of an interest in property"

In other words, this provision permits relief from stay when Cr's interest in property lacks adequate protection. Only available to holders of an interest in Dr's property--i.e., does not apply to unsecured Crs.
This area is fact intensive--no clear rules as to what constitutes adequate protection-make the argument.

b. Three types of *adequate protection:*

These aren't exclusive; any means by which the trustee can assure protection of the claimant's interest can be tendered as adequate protection; these 3 are just the ones enumerated in the statute.

(1) Cash [361(1)]**;**

(i) If the estate has sufficient income, it can make cash payments to the claimant to reduce the debt and maintain the ration b/t the claim and the property value.

BUT, Dr rarely has free cash to do this.

(a) Litigation will be over what constitutes adequate payment.

(2) Providing Additional Collateral [361(2)]

(i) If there is unencumbered property in the estate, the trustee can provide adequate protection by granting a lien on additional property or replacing hte existing lien w/a lien on property of greater value.

But to what extent does Dr have free unencumbered assets laying around on which to place the lien?

(3) "Such other relief" of the "indubitable equivalent" [361(3)]

(i) "Indubitable equivalent" = avoidance power recoveries.

(a) EXA: Dr can offer to give Cr % of lien on those proceeds in lieu of a lien.

(b) Fuzzy standard--so tough for Cr to establish.

3. *Relief where Dr has no equity in property and property not necessary for effective reorganization [362(d)(2)]*

i. Situation: Cr wants to foreclose on a piece of property in a Ch. 11 proceeding, but the property is underwater (i.e., over-encumbered--value of property < amount of debt).

Only applies in Ch. 11 cases--no reorganization in Ch. 7.

ii. Two Requirements:

a. D has no equity in property; <u>and</u>

(1) Dr's equity = value of property - all encumbrances.

(i) No equity means value of debt is greater than the value of the property.

i.e., this is equity with respect to the particular piece of property, not equity in Dr.
EXA: Dr has piece of equipment with FMV of $700k; debt with respect to that equipment is $1M. There is no equity in this property.

(a) Can take into account the **assembly value (i.e., turnkey value/value as a going concern)**

(a) Might be much higher than item by item liquidation value.

(b) If you argue that there is no equity, cannot later move for an award of fees, interests and costs under 506(b), b/c fees, interests and costs can only go to oversecured Crs. Arguing for relief

from stay under 362(d)(2) may judicially estop the Cr from claiming fees, costs and interests under 506(b), b/c you're admitting that you are not oversecured.

b. Property is not necessary for an effective reorganization

(1) If Ch. 7 Dr, then de facto the property is not necessary to reorganization.

(i) This is true even if the assets in the aggregate are worth more than the assets sold piecemeal.

(ii) This provision is usually used as a bargaining chip

(a) Dr will challenge relief from stay by arguing assets are necessary to effective reorganization

(a) Leads to lots of litigation over the "feasibility" of Ch. 11 reorg.

4. Single Asset Real Estate [362(d)(3)]

i. "*Single Asset Real Estate*" = Dr (other than a family farmer) derives substantially all of its gross income from the rental of a single piece of real property that is either used as commercial premises or as an apartment complex larger than 4 units. [101(51)(B)]

ii. **Situation**: D owns one apt. building. This kind of entity usually has very few Crs other than a single lender (but may have several unsecured Crs, such as landscapers, janitors etc).

a. Lots of sham Ch. 11's filed by these entities in order to play games w/Lender

iii. **Solution**: Quick trigger relief from stay where the action is against a single asset real estate and the Cr is secured by an interest in that real estate.

a. EXCEPTION

(1) Dr files plan of reorganization that has a reasonable possibility of being confirmed w/in a reasonable time [363(d)(3)(A)]; **or**

Not gonna happen--Lender's claim will control voting on the plan.

(2) Dr has commenced monthly payments that [362(d)(3)(B)]:

Not gonna happen--No money to do this

(i) May be made from rents/other income generated by/from the property to each Cr whose claims is secured by the real estate; **and**

(ii) Are equal to interest at the K rate

iv. Stay is not available if there is an **equity/rent skimming scheme** [362(d)(4)]

a. Situation: Dr, sometimes with the collusion of other entities, files successive bankruptcies to frustrate the foreclosure of a S/I in RP.

b. **Solution:** I.e., relief not available if court finds that the bankruptcy is part of a scheme to **delay, hinder and defraud** Crs that involve either:

(1) Transfer of all or part interest in the RP **or**

(2) Multiple bankruptcy filings affecting the RP

(i) EXA: D1 w/RP. C forecloses. D2 files bankruptcy on RP1, C gets approved to nonjudicial foreclosure. D3 files bankruptcy on RP1, etc. Ds keep transferring fractional interest upon foreclosure in order to delay foreclosure.

(a) Two types of schemes

(a) Scheme 1: Your house is going to be foreclosed, you go to a "foreclosure expert" (i.e., a fraudster)--an active participant.

(b) Scheme 2: Foreclosure fraudster goes to houses and have people sign authorization forms--unknowingly signing over title of property...fraudsters evict people from home, then they rent out the properties at pretty good rates, but tenants don't know that these people are fraudsters.

E. Miscellaneous Ways to Try to Get Out of Automatic Stay

1. Contractual Waiver

i. Waiver by Drs in a credit agreement = **per se invalid**

ii. BUT, if Cr allows Ch. 11 to go through and includes language in the plan that if reorganization fails, stay will be waived in a future Ch. 11 = **valid**

2. *Covenants from Gr (Indirect Stay Waiver)*

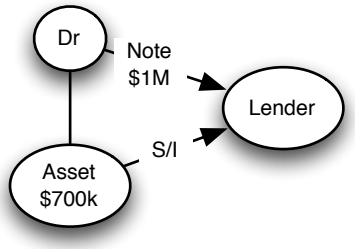
i. EXA: Dr, Cr, and Gr SH. Dr can't execute valid waiver of stay; but in documentation surrounding guarantee, can include covenants stating that Gr will do everything in power to compel Dr not to oppose motion for relief from stay.

a. This may work, but provides evidence of Cr control of Dr-->Equitable Subordination

F. Determining Secured Status

1. *Bifurcation of Claims* [506]

i. If you're undersecured, your claim is bifurcated into two parts.



a. Dr with an asset worth $700k. Lender has a note for $1M secured by the asset. So the Lender is secured up to $700k, and undersecured w/respect to $300k.

ii. If you're oversecured, the value of the collateral exceeds the value of the debt, meaning there is a surplus in terms of the amount to which Cr is secured.

2. To the extent Cr is **oversecured**, Cr is entitled to interest on the claim and reasonable fees, costs [506(b)]

i.e., oversecured Crs get interest, fees and costs--this comes from the surplus of security over the value of the collateral.

i. EXA: Cr suing Dr on prepetition litigation. Can probably recover interest, fees and costs on those claims in banktuptcy.

ii. EXA: Cr is being sued in bankruptcy. Cr prevails. Can Cr now collect those fees from the estate?

a. Split

(1) Atty fee clause must specify that Cr is entitled to fees in the event of bankrtupcy.

(2) But some courts say you can't recover these fees (minority view).

iii. Interest at what rate?

a. Cr wants interest at default rate--courts won't give it to you (only gives little bump over base rate, but not much), even though Dr may be in default.

iv. Reasonable fees

a. Must be reasonable

v. Cal Civ Code 1717

a. Converts unilateral fee clauses into reciprocal fee clauses.

3. *Costs of Realizing or Preserving the Collateral ("**Surcharge**")[506(c)]*

i. The trustee may need to take action to preserve or realize collateral.

a. If so, the reasonable and necessary costs and expenses of doing so can be recovered from the collateral to the extent of any benefit to the secured Cr.

(1) EXA: Secured party has S/I in fruit. Estate has to take care of that fruit. Estate is entitled to reimbursement for taking care of that fruit, b/c its for the benefit of the secured party.

(2) EXA: Management that stays w/Dr through Ch. 11. Maybe they get paid, but not benefits/vacation time etc. If there services are necessary for the successful reorganization, these people sometimes seek surcharge for their services or have Dr do it on their behalf.

(i) However, if a Lender serves as a DIP financer, it may require sweetners that prohibit this.

VII. EXECUTORY CONTRACTS [365]

A. Definition of "Executory Contract"

1. ***Countryman Test*** (accepted test): A K is executory if the obligations of both parties are so far unperformed that the failure of either to perform would be a material breach (i.e, performance is due on both sides).
   i. If either side has fully or substantially performed, , then the K is no longer executory.
   ii. If the K terminated prior to bankruptcy (either b/c its term ended or b/c one of the parties rightfully cancelled it) it is not executory.
2. ***Functional Approach*** (what courts do in practice): Court takes into account the materiality of the unperformed portion of the K as well as the impact the K will have on the estate by allowing the trustee to assume or reject the K.

   i.e. courts reach the decision they want. Court will strive to make decisions that are economically beneficial to the estate.

B. Estate's Right to Assume or Reject Executory K

1. *Authorization* [365(a)]

   i. Trustee may assume or reject any executory K or unexpired lease of Dr w/court's approval.

   Trustee must determine whether the K is economically good for the estate or not.

2. *Distinction b/t Bilateral and Unilateral Obligations*

   i. Unilateral obligation = one side has performed, other side has yet to perform.
      a. If Dr has fully performed its obligations by the time of bankruptcy, then the outstanding performance due by the other party = a right of the Dr's that becomes property of estate.
      b. If other party has fully performed, Dr's obligation gives rise to prepetition claim to be proved and paid.
   ii. Bilateral obligation = performance due by both sides.

3. *Assuming and Rejecting Executory K*

   i. Assuming K
      a. If estate assumes K, estate is entitled to receive performance and Dr is liable to perform.
         (1) Performance due by Dr = administrative expense and so gets priority.

   ii. Rejecting K
      a. Trustee's election to reject K = breach by Dr.
      b. Other party becomes a Cr and its claim for damages is treated as a general unsecured prepetition claim. [365(g)(1)].

C. Limitations on the Ability of the Estate to Assume/Reject Executory Ks--Must Cure Defaults [365(b)]

1. *Estate cannot assume an executory K without* ***curing past defaults***. [365(b)(1)]

   i. Must either **cure, or provide adequate assurance that trustee will promptly cure** a non-breach default **or**
   ii. Compensate, or provide adequate assurance that trustee will promptly compensate, the other party for any actual pecuniary loss resulting from default.

2. *Certain types of defaults do not have to be cured*[365(b)(2)]:

   i. Ipso Facto defaults

   Can't be cured, and don't have to be cured. Ipso fact clause = provision in a K that allows the non-Dr to declare default or terminate the K on the grounds that Dr is insolvent/filed bankruptcy.

a. Default that is a breach of provision relating to the insolvency or financial condition of the Dr at any time before the closing of the case[365(b)(2)(A)];
b. Default that is a breach of provision relating to the commencement of a bankruptcy case[365(b)(2)(B)];
c. Default that is a breach of provision relating to the appointment of or taking possession by a trustee in a bankruptcy case or as a custodian before such commencement[365(b)(2)(C)];

ii. Non-dollar defaults

a. Default that is a breach of provision relating to the satisfaction of any penalty rate/penalty provision relating to a default arising from Dr's failure to perform nonmonetary obligations under an executory K. [365(b)(2)(D)].
   (1) To extent K provides penalty for a non-dollar default, that default doesn't have to be cured (i.e., **liquidated damages provisions resulting from non-dollar default do not have to be cured**).
      (i) EXA: Auto dealer, which is franchisee of manufacturer. Manufacturer/franchisor wants the dealer always open to represent your interest. Franchise agreement often has a provision saying if franchisee goes dark (doesn't continually operate), then the franchise is terminated. There is a liquidated damages provision in the event franchisee goes dark. The liquidated damages provision will not be allowed.
         (a) BUT, if there is no liquidated damages provision, and instead the agreement says if you go dark then the agreement is terminated, (b)(2)(D) does not apply--you cannot cure this default and the agreement is over.
         (b) English: If K provides for non-dollar default without a penalty provision attached, the default can't be cured and the agreement can't be assumed by the estate.
b. **EXCEPTION**: If there is an unexpired lease of RP, then the trustee does not have to cure non-monetary defaults; but if the default has to do with "going dark," then the default has to be cured when assumed, and any pecuniary losses have to be compensated. [365(b)(1)(A].

D. Nonassumable Ks [365(c)]

1. In the absence of consent by the other party, assumption is not available if nonbankruptcy law excuses the other party from accepting performance from or rendering performance to someone other than the Dr or the DIP (i.e., assignment). [365(c)(1)].
2. *Three types of non-assumable Ks*

i. Ks that are not assignable in nonbankruptcy law [365(c)(1)]

a. *Catapult*: Non-exclusive IP license; DIP seeks to assume but not assign this non-exclusive license. Non-exclusive licenses are not assignable under federal law; exclusive licenses are assignable. If exclusive, its almost like being the owner of the license. DIP argues the fact that it isn't assignable should be irrelevant, b/c DIP doesn't want to assign it. However, licensor says the statute says trustee can't assume or assign an executive K if non-bankruptcy law permits the lessor to refuse substitute performance. *Held*, since federal law says a non-exclusive license is not assignable, this means the estate can't even assume it.
   (1) Hypothetical Test (*Catapult* holding)
      (i) If nonbankruptcy law bars the assignment of the contract to a hypothetical third party, it cannot be assumed by the estate, whether administered by the trustee or DIP.
         (a) Focuses not on whether the party to perform the K (i.e., DIP) is functionally the same as the Dr, but asks instead whether a hypothetical 3rd party would be allowed to take over the K.
   (2) Actual Test
      (i) If the trustee is not actually going to assign, then no problem.

JDX split about whether Hypothetical or Actual test applies.

ii. **Estate cannot assume an agreement to make a loan** [365(c)(2)]

a. This just leads to prepackaged bankruptcies, where everyone agrees to an arrangement where lender provides financing when Ch. 11 is filed. Although 365(c)(2) says you can't do this, nobody says boo b/c it is good for everyone, including the courts (easy to administer).

iii. Cannot assign a personal services K

E. Time Frame [365(d)]

1. In a Ch. 7, must assume or reject w/60 days of filing or else automatically rejected [365(d)(1)]
2. In Ch. 11 cases, trustee can assume/reject at any time before confirmation of a plan. [365(d)(2)]
   i. But the court can order a specific timeframe upon the request of another party.
3. Court can extend period of time for additional 60 days (total of 120 days). [365(d)(3)]
   i. Trustee is responsible performing any obligations (such as paying rent) until a decision is made.

WHAT ABOUT (d)(4)????--he just mentions it briefly--120 day window for real estate and estate has to keep paying is all he said.

F. Termination of Executory K [365(e)]

Go here if there is a post-petition default.

1. Executory K may not be terminated or modified due to ipso facto defaults **after Dr files** (i.e., 365(b)(2)(A)-(C)).
   i. In other words, ipso facto defaults are not grounds for termination by non-bankruptcy party.
      Different from 365(b), which talks about what has to be cured; here we are talking about what kinds of defaults can give rise to termination by non-bankruptcy party.
2. EXCEPTION [365(e)(2)]: You can terminate under ipso facto clause if applicable law says you don't have to accept performance from a 3rd party.
   But courts are split; and if you can terminate, still must seek relief from stay.
   i. EXA: Partnership dissolutions. The UPA says that the bankruptcy of a partner dissolves a partnership, and the partnership need not accept performance from another party. In this case, the courts are in conflict.
   ii. EXA: Personal services Ks.

G. Assignment of Executory K[365(f)]

Get here if K there is either no post-petition default, or if there is a post-petition default but non-Dr can't terminate (ie ipso fact default) or doesn't terminate, then look to whether it can be assigned

1. **Situation**: Trustee is unwilling/unable to take on the burden of performance even though the K is advantageous to the estate. In this case, it may be most advantageous to the estate to assume the K and then assign it.
   i. **The trustee can assign an assumed K so long as the assignee provides adequate assurance of future performance.** [365(f)].
      a. Sounds like it conflicts w/365(c), b/c 365(c) prohibits assumption if applicable law excuses the nondebtor from accepting substitute performance, while 365(f) makes a K assignable notwithstanding a provision in the K or in applicable law that prohibits assignment.
         (1) *Catapult* court says that 365(f) talks about express prohibitions on assignment; 365(c) talks about accepting substitute performance from a substitute party.
            (i) Assignment is a broader concept; acceptance of substitute performance is a very narrow subject.
            (ii) "365(f) invalidates contractual anti-assignment clauses, and overrides nonbankruptcy laws that generally uphold anti-assignment clauses in Ks, or generally prohibit the assignment of contract rights. 365(c) gives effect to nonbankruptcy law that makes certain specific types of K unassignable, whether or not the K contains an anti-assignment clause. Therefore, although 365(f) generally renders ineffective anti-assignment clauses and nonbankruptcy laws that preclude assignment, it is qualified by 365(c) when the rule of nonbankruptcy law is designed to protect the legitimate expectations of the nondebtor party in circumstances where the transfer of a particular type of K would damage those expectations."
2. *Requirements for Assignment* [365(f)(2)]

i. If assignment is permissible, trustee may assign if:

a. Trustee assumes K and

b. Adequate assurance of future performance is provided by assignee (i.e., not the estate).

Cr has no recourse against the estate of the assignee breaches.

H. Relief for liability from breach after assignment [365(k)]

1. K or lease that is assumed and assigned relieves trustee and estate from any liability for any breach of K occurring after assignment.

i.e., assignor has no continuing liability.

I. Special Cases

1. Shopping Centers

i. **Situation**: T1 builds a shopping center, and there are multiple tenants. Lender has taken a note from T1 and a leasehold deed of trust (LTD--mortgage on leasehold), and holding the LTD as collateral. So if there is a default, lender can foreclose and transfer the leasehold. T1 files bankruptcy, and the long term lease is either rejected outright or deemed rejected under 365(d). This is a problem for Lender.

a. **Best solution**: Before Lender takes LTD, get cure agreement w/LL where in the event of default Lender will maintain property, pay rent, and sell the property.

ii. **Cure** -- Shopping Center Leases [365(b)(3)]

a. **Situation**: You're a shopping center LL, and one of your T's goes bankrupt.

(1) "Shopping Center"

(i) Definition varies

(a) Factors:

(a) Shared parking

(b) Architectural style

(c) Etc.

(2) Adequate assurance for shopping center lease:

(i) Source of rent and other consideration due under the lease;

Easy to manipulate

(ii) Where there is a proposed assignment, that the financial condition and operating performance of the proposed assignee and its Grs are similar to that of Dr and its Grs. [365(b)(3)(A)]

(iii) % rent due under lease doesn't decline substantially [365(b)(3)(B)];

(iv) No breach of any terms of the lease or any other lease involved w/the shopping center [365(b)(3)(C)];

(v) No disruption of tenant mix/balance in shopping center [365(b)(3)(D)]

Easy to manipulate

(3) CA Statute

(i) In master lease can have provisions saying assignment can be at consent of LL and LL can get a piece of any increase value assignor would otherwise get.

(a) Doesn't work in bankruptcy. Assignor (Dr's estate) gets to keep all the extra money, and LL's consent is not required (b/c estate has the ability to assign).

2. IP Licensing [365(n)]

i. **Situation**: Bankrupt licensor who wants to reject the license, but licensee wants to keep the license.

ii. If trustee rejects IP license, licensee can either:

a. Keep license open; or

b. Treat as breach.

VIII. CHAPTER 11

A. General Provisions

1. Can be commenced either voluntarily or involuntarily.

2. *Trustee can operate the Dr's business.* [1108]

   i. DIP (Dr in possession) has all powers/duties of trustee. [1107(a)].
   Therefore, DIP can operate Dr's business during the bankruptcy.
   Different from Ch. 7, where the only goal is to wind out the business

3. *Replacing the DIP for **Cause***

   i. If DIP = incompetent/dishonest, court can replace w/true trustee. [1104(a)(1)].
   Will often instead just convert to Ch. 11, unless it looks like a good Ch. 11.

4. *Crs Committees*

   i. A committee of unsecured Crs appointed by the trustee/DIP to represent the interests of the Cr body as a whole or, if more than one committee is appropriate, a class of Crs. [1102(a)(1)]
   Trustee/DIP has to appoint at least one committee of unsecured Crs.

   ii. **Powers/Duties** [1103]

      a. Oversight of the Ch. 11 [1103(c)]
      Generally the committee is weak; composed of credit managers, debt already written off, so DIP can push them around, UNLESS it's a big Ch. 11.

      b. Power to prosecute claim on behalf of estate?
      Unresolved--as it stands, NO power to prosecute, only DIP can do so.

         (1) The committee is empowered to "take other such actions as are in the interests of those represented" [1103(c)(5)]

         (2) However, 503(b)(3)(B) suggests that a Cr can recover assets for the estate and get paid for its costs for doing so.
         Some courts say the committee's only option is to move for a Ch. 11 trustee if the DIP is sitting on potential COA's to protect insiders.

5. *Classification of Crs*

   i. General Rule: Substantially similar classes must be grouped together unless there is an articulable business justification for separate classification. [1112]

      a. "*Substantially similar*" = same quality (secured/unsecured) and same priority.

         (1) Possible Exception: Critical Vendor Argument

            (i) Remember the broadway lightbulb union case (where trustee was able to isolate one Cr that fit into a broader class into its own class b/c the union threatened to strike, and thereby cripple the Dr).

B. Cash Collateral Fight

1. This will typically happen immediately upon filing.

2. *General Rule*

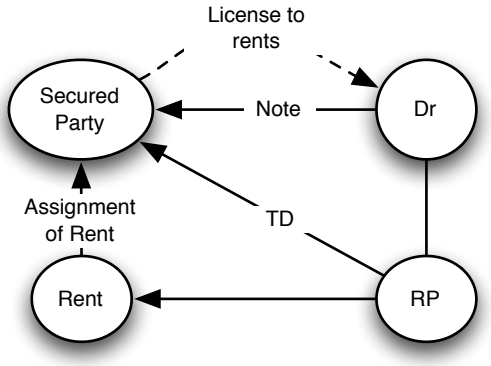
   i. Property acquired by the estate/Dr after filing is not subject to any lien entered into pre-petition. [552(a)]
      a. So if Dr gets rent income after commencement of case, it belongs to the estate and is free of any lien.

3. *Exceptions*

   i. Rents from RP

      a. Despite 552(a), if Cr has a S/I in Dr's rents from RP before petition, that S/I is still good after petition. [552(b)(2)].

(1) **EXA**: Dr has a piece of RP. RP spins off rents. Secured party holding Dr's note, TD on RP, and an assignment of rents (i.e., S/I on the rents). Secured party grants a license back to Dr to use the rents, but license terminates in the event of default.



(i) So even though rents arise post-petition, the S/I created by the assignment of rents extends to those rents.

ii. Non-rents (i.e., A/R, inventory)

a. Problem of Fading Perfection

(1) **Situation**: Dr w/pre-petition inventory. Secured party holds a note and S/I in inventory. Petition is filed. Inventory is sold to customers, which results in A/R. Although the secured party had an S/I in pre-petition A/R, these are post petition A/R.

(2) Rule: If you can show that the proceeds are the product of the pre-petition stuff, then the S/I will apply.[552(b)(1)]

(3) **Problem**: If these are proceeds of the earlier A/R, then the S/I applies--but how do you know?

(i) If estate puts new effort/labor in generating the receivables, then to what extent are those receivables really proceeds? If not proceeds, then S/I doesn't apply.

(ii) If not proceeds, then we flop back into 551(a), and estate gets to keep it.

(iii) So the key question is: ***At what point is the value received the product of the asset pre-petition, and at what point is the value received the product of the estate's post petition efforts.***

(a) Essentially this is a tracing problem.

b. Solution [363].

(1) "*Cash Collateral*" = cash or cash equivalent that is subject to an interest held by someone other than the estate. [363(a)]

In other words, the cash that results from these sells by Dr = proceeds.

(2) Trustee/DIP can operate business of Dr, enter Tx in the ordinary course, and use estate property in the ordinary course of business w/o notice or hearing. [363(c)(1)]

(i) EXCEPTION: Trustee may not use, sell or lease cash collateral unless [363(c)(2)]:

(a) Each entity that has an interest in such cash collateral consents; or

(b) The court authorizes such use/sale/lease

In other words, DIP can operate the business, but can't use cash collateral w/o everyone agreeing or the court approves the use of cash collateral in the absence of an agreement

(a) Court will authorize the use of cash collateral in the absence of an agreement only to the extent that there is **adequate protection** to the other entities w/interest in the cash collateral [363(e)]

+ Adequate protection will usually come in the form of Dr agreeing to make periodic payments.

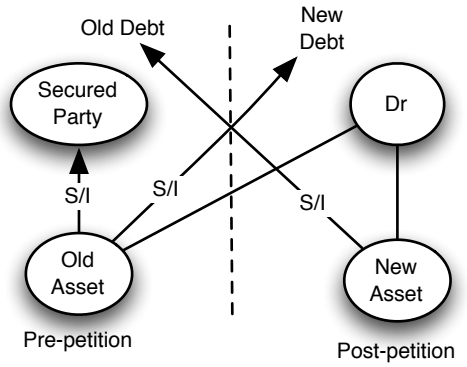
4. *Cash Collateral Stipulations* (i.e., 363(c)(2)(A)]

i. Crs and Drs generally come to a stipulation over what will be adequate protection

a. Cross Cash Collateralization Clauses

(1) **Situation**: Secured party owed money from Dr. Dr has asset. Cr has S/I in asset (all prepetition).

stipulation, the secured party will want the old debt to be secured by the new assets and have the additional debt be secured by a S/I in the old assets.



(i) This doesn't fly in CA courts (it is a clear preference)

(ii) But Schechter disagrees--this solves the problem of tracing so it is useful.

b. Changes in Priority

(1) Can't have this

c. Waivers of 506(c)

(1) 506(c) allows C to surcharge the assets of the estate if the estate for services performed during Ch. 11.

(2) May not be valid in 9th Circuit

(3) Courts don't like this one, especially if the lender tries to bury it in the order so that the lender essentially sandbags the judge.

d. Waivers of Certain types of Plans

(1) Court won't allow it--do not want to handcuff the estate and this subverts the plan.

e. Waiver of Pre-petition claims

(1) Court won't allow this. [524(e)]

(i) 9th Cir has interpreted this language broadly; court reads it that to the extent Dr is filing bankruptcy and getting out if its debts, no one else can; court can only protect the Dr.

f. Waivers of Causes of Action

(1) Can't do this--we have settlement procedures for this.

g. Waiver of Auto-Stay

(1) Nope for obvious reasons.

h. Waiver of Foreclosure Procedures

(1) Nope--this is governed by state law, so can't waive it in this agreement.

i. Waiver of 363

(1) No good.

j. Waiver of a lien for granting of another lien in excess of the original lien.

(1) No good.

k. Provisions providing for the paying down of pre-petiiton principle.

(1) Preference, so no good.

5. Court Ordered Protection of Cash Collateral

i. **Dr has a duty to protect cash collateral** (*supposedly*).

a. Typically Dr is ordered to deposit cash collateral into a special **"lock box account"**

(1) This is not necessarily done, so collateral can be wasted away, b/c it is hard to trace the money (pre v. post petition).

(i) I.e., Cr needs to make sure that there is a lock box account that is separate and distinct from the general funds account of Dr.

(2) Cr should make sure that in addition to lock box account, Cr gets supervisory authority as well.

b. **Problem**: "Paid in Full" on checks paid to Dr

(1) Best policy for C: make sure Dr's checks are going into your bank account, so you can set the policy that checks marked paid in full should be rejected or cashed under protest.

c. **Problem**: Dr promises to make payments to you; how are those allocated, to interest or principle?

(1) Solution: Lay it out in the cash collateral stipulation.

6. *Interest for Undersecured Crs* [506]

i. Problem: 506(b) says if you're oversecured then you can get interest to the extent that you're oversecured. Cr = undersecured. Dr wants to use your collateral, and you are denied the right to foreclose. May seek relief from stay for cause [362(d)(1)] b/c there is lack of adequate protection of an interest in property. Undersecured C will argue that it has lost its right to foreclose, which is an interest in property, and so it ought to be compensated or granted relief from stay. Here, the argument is that adequate protection = time value of cash C is not getting. If C were to foreclose, it could foreclose and get the money NOW. (*Timbers* argument)

a. Timbers: 506(b) says oversecured Crs get interest; it doesn't say undersecured Crs. So undersecured Crs don't need adequate protection.

(1) Open issue: Undersecured C wants to submit a claim for interest and fees (but don't want to get paid out of collateral or 'out of administrative expenses), can you submit an ordinary claim?

7. *Surcharge of Collateral Under 506(c)*

Remember, surcharge means that if the efforts of the estate preserved the collateral for the benefit of the lender, then the estate can ask for a little something extra for compensation for the the preservation.

i. Hartford: Dr files bankruptcy. WC carrier provides coverage, which keeps workers at work, thereby enhancing the value of the secured party's collateral (otherwise, everyone walks off, and the collateral is worthless). Carrier **unilaterally** applies to the court for a surcharge on the collateral under 506(c). *Held*, **only the trustee/estate can petition for surcharges under 506(c).**

a. This provides an opportunity for the secured party to try to extract a waiver of 506(c) by Dr, if court approves.

ii. Footnote 5 of *Hartford* leaves open the possibility that Dr can sell COA (eg, 548) to a 3rd party.

a. Assignment of Causes of Action

Works in 9th Cir.

(1) Issue: Can the estate sell its COA (e.g., preference avoidance action) to a third party?

(i) Schechter thinks this may be possible.

(ii) HOWEVER, 550(a) says there must be some benefit to the estate. To what extent must the estate benefit from the recovery on the action?

(a) Potential Arrangements

(a) Assignee prosecutes on behalf of estate, get compensated, but recovery (minus assignee's fee) goes back to the estate.

Clearly this is an assignment for the benefit of the estate.

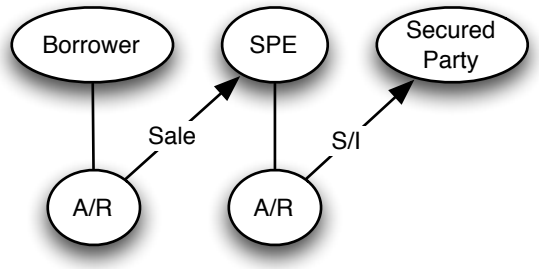
(b) Fee splitting arrangements

+ 50/50 probably okay; Less than 50/50 probably okay.

8. *Ways of Avoiding the Cash Collateral Problem*

i. Bankruptcy Remote Entity

a. Situation: Prepetition, there is a borrower, and Cr has a S/I in A/R. Borrower creates an SPE. Borrower sells its A/R to the SPE. Cr has a S/I in those receivables. Goal is to make the SPE bankruptcy remote--it has no other Crs. Form of securitization.



(1) If Borrower goes into bankruptcy, SPE is not in bankruptcy.

(2) Issue: To what extent are the assets of the SPE really just assets of the borrower (substantive consolidation?)

C. Preparation of the Plan

1. Exclusivity

i. **Dr has exclusive power to set up the plan** [1121].

a. However, exclusivity can be terminated after 120 days.

(1) If Dr's plan is not accepted w/in 120 days, may get another 60 days to amend and get approval.

(i) After that, other parties can submit a plan for approval.

D. Solicitation

1. Once Dr puts out the plan, the Dr then seeks to solicit acceptances under that plan.

i. Must get disclosure statement approved

Basically asking for support of Crs

ii. Crs vote to accept/reject the plan.

iii. To ensure that these parties are given sufficient info on the plan and the Dr's affairs before they vote, the proponent of the plan must draft a disclosure statement containing **adequate information.** [1125]

a. Appropriate Disclosure

(1) Not much limit in what Dr can do in propounding plan

(i) Dr is exempt from usual security rules [1125(d)]

(1) But Schechter thinks the courts just use their discretion.

(a) EXA: Mastermind buys up existing shell corporation that was formerly a PTC, but now dormant. Buys up bad debts of the company owed to the company by other Crs. now takes company into Ch. 11, offer shares to the public/investors. Court ultimately dinged this Ch. 11 as being in bad faith.

(ii) Safe Harbor [1125(e)]

(1) Protects persons who violate nonbankruptcy regs in the solicitation of votes or issuance of securities under the plan so long as they act in good faith and in accordance w/Code.

2. Opposing the Plan

i. Arguments:

a. Bad plan;

b. Exclusivity should be terminated

ii. Can communicate w/other Crs

Need to be careful--too much communication may start to look like you're propounding your own plan/ solicitation of a competing plan even during exclusivity.

iii. Disposition of Claims

a. You can buy and sell claims.

b. Current trend seems to be that you can buy up claims even if the purpose is to build a blocking position when it comes to voting on the plan.

E. Voting on the Plan

1. *Goal* = consensual plan where all involved agree to keep Dr alive.

i. However, a big (secured) Cr usually wants Dr dead.

a. EXA: Dr w/single piece of RP worth $1M. Secured party holds TD on RP w/note from D at $1.3M. TC have claims of $100k. Here, the secured party's claim is secured up to $1M, but unsecured as to the remaining $300k. Claim gets bifurcated into secured and unsecured parts. Secured party wants that liquidated to get the $1M back. Problem: If when we classify Crs we lump together the secured party's unsecured $300k w/the TCs, we'll never get a consensual plan. (see below for solution to this).

2. *Class Voting*

i. All claims and interests are divided into classes.

ii. Each class forms a voting block.

F. Acceptance of Plan [1126]

1. *Requirements for Acceptance*

i. In order to find that a class has accepted a plan, need **2/3 in dollar amount** (supermajority) to approve, **and 1/2 in number** to approve. [1126(c)].

2. *Unimpaired class does not get to vote.* [1126(f)]

Conclusively deemed to have accepted the plan.

i. "**Impairment**" = alteration

But not necessarily hurt--any change will constitute impairment. So if you're rights are unaltered under the plan, you don't have a right to vote.

a. A plan is impaired unless it leaves unaltered the legal, equitable, and contractual rights to which such aclaim or interest entites the holder of such claim or interest. [1124]

G. Confirmation of Plan

1. *Requirements*

i. Best Interests Test [1129(a)(7)]

a. The court shall confirm a plan only if each holder of an impaired claim either:

(1) Accepts the plan; or

(2) Gets as good of a distribution as the Cr would in Ch. 7

So must look to see whether each consenting C will receive the same amount in a hypothetical Ch. 7

ii. Acceptance by classes of claims and interests [1129(a)(8)]

a. With respect to each class of claims/interests, each class must either:

(1) Accept the plan; or

(2) Not be impaired under the plan.

So if there is one class that is impaired but does not accept, the plan can't be confirmed. Because of the broad application of "impaired", this basically means there must be no non-consenting classes (i.e., everyone accepts)

b. **EXCEPTION** [1129(b)(1)]: **Cramdown**

(1) The court can confirm the plan even if 1129(a)(8) is not satisfied if the **plan does not discriminate unfairly <u>and</u>** is **fair and equitable** with respect to each impaired class that has not accepted the plan**.** If this exception applies, must still comply with 1129(10).

(i) Unfair Discrimination [1129(b)(1)]

(a) Factual question.

(b) Generally, the class that has rejected the plan must receive treatment under the plan consistent w/that being given to other classes who have comparable legal rights.

(a) Discrimination (i.e., different treatment) is okay, as long as it isn't unfair.

(ii) Fair and Equitable [1129(b)(1)&(2)]

(a) Tests for Fair and Equitable:

(a) Unsecured claimant either gets **paid in full**; **<u>or</u>**

(b) Absolute Priority Rule

+ If there is a cramdown, and there are multiple classes, and there are junior classes, and there is a junior class not paid in full, then no class junior to the not paid in full class gets anything.

i.e., equity gets nothing.

+ EXA: **Leapfrog**: Dr, Senior Cr, Junior Cr, and equity holders. Under the confirmed plan, Senior is going to get 90 cents per dollar; junior C gets 25 cents on dollar, nothing for equity. Senior Cr agrees to give 10 cents on the dollar to equity holders outside of the Ch. 11 arrangement, in order to encourage the equity holders to stay on. Courts are split on whether this is okay, b/c it is rearranging distribution among the Crs. Won't work b/c of absolute priority rule.

+ Unclear whether **new value rule** still applies.

+ **<u>New Value Rule</u>**: If a junior class puts in new value into the plan, can they get something under the plan even though there is an unpaid class ahead of them?

-- *203 North Lesalle*: To the extent that the equity holders are the exclusive party w/ the right to obtain equity in the reorganized entity, then that exclusivity itself is a property interest. They are getting the opportunity to participate on account of there status as equity holders. Equity holders claimed they were receiving distribution b/c of "sweat equity"" but court doesn't buy it. Court seems to hint that if you have an auction of the option to acquire stock in the reorganized entity, then the equity holders might be permitted to participate in that on par w/other entities. **In an appropriate case, you can have a plan that violates the absolute priority rule by awarding new value to equity holders if and only if the equity holders submit to an auction of their right to purchase the entity.**

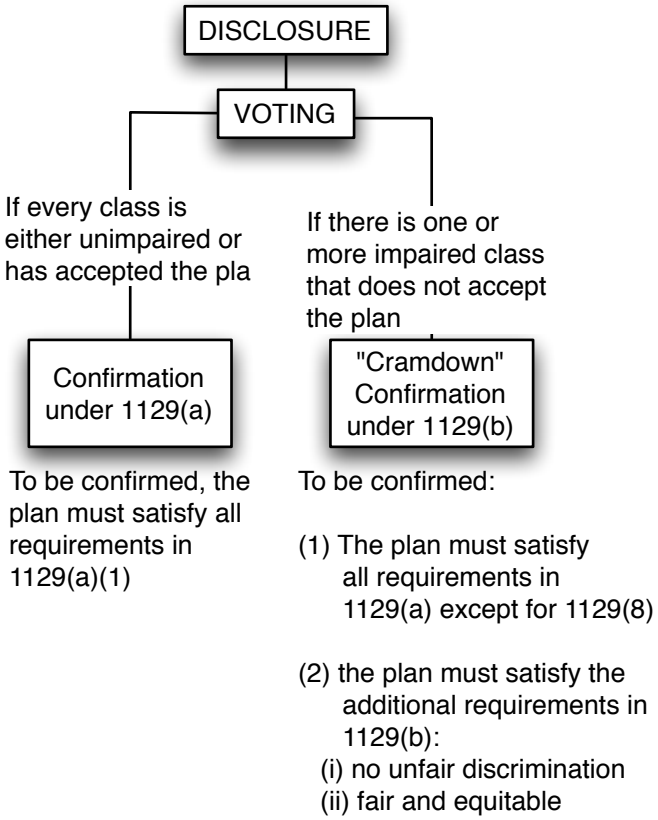
So, can't have exclusive new value plans, but if the new value plan is auction based it might fly.

2. *Requirement of at least 1 Impaired Consenting Clas*s [1129(a)(10]

TRIGGERED BY CRAMDOWN

i. If a class of claims is impaired under the plan, at least one class of claims that is impaired under the plan must accept the plan, determined w/o including any acceptance of the plan by an insider.

Bottom line: if you don't have all of the impaired classes consenting, you can't satisfy 1129(a)(8); but if you have at least one impaired consenting class, you can satisfy 1129(a)(10).



H. Post-Petition Financing [364]

1. Valid Methods of Obtaining Post-Petition Financing

i. Unsecured debt incurred in the ordinary course of business [364(a)]

YA RIGHT! Not gonna happen--no one wants to lend to a loser.

ii. Unsecured debt outside the ordinary course of business-- unsecured credit from an "administrative Cr" [364(b)]

a. Administrative Crs are unsecured, but get priority ahead of general unsecured Crs.

Also not likely to happen--don't want to be unsecured, even if you're up in priority.

iii. Secured or superpriority credit [364(c)]

a. Court may authorize either:

(1) Superpriority for the debt (placing it ahead of administrative expenses);

(2) Allow trustee to secure the debt by a lien on unencumbered property; **or**

(3) Allow trustee to secure the debt by a junior lien on encumbered property.

iv. Priming Lien [364(d)]

a. Estate can borrow money and offer super-priority (i.e., priority even over secured Cr).

Encourages secured Cr to lend to Dr for fear of getting primed.
Previously secured Cr needs adequate protection.

b. Situation: Two secured Crs on same collateral, one senior and one junior. Senior doesn't grant post-petition financing, but junior does.

(1) Here, only the post-petition financing gets priority, not all of junior C's interest.

2. Administrative Expenses

i. Includes your atty fees

a. So in any financing agreement, make sure you make a carve out for your fees--so that a post-petition lender doesn't take priority over your share.

ii. Problem: Dr with A/R that turns over into cash. DIP lender has S/I in those funds. Dr turns around and pays you your fees as atty. Are you liable for the tort of conversion?

a. Courts are in conflict.

(1) Under Article 9, if you are a payee of funds, you take free of a security interest, unless payee is in collusion w/Dr.

I. First Day Orders

1. What they are: Request by Dr for ability to pay off old debts so Dr can continue receiving new goods.

i. May include a waiver of preference claims

Schechter thinks these orders are no good.

a. Won't be signed by court in CA; will be signed in DE.

2. Situation: Dr files Ch. 11. Vendors get nervous, would prefer selling somewhere else. May demand COD terms (onerous on financially distressed Dr) or may not be willing to ship based on promise of administrative priority. May request a first day order.

J. Sale of Assets of the Estate (other than COA's) Outside the Ordinary Course

1. Bidders fees

i. Corp wants to sell a division. Bidder (**stalking horse**) comes in, does due diligence, and makes initial offer--sets market. Other bidders come in and bid.

a. Some bidders/DIPS have entered into **break up fee/topping fee arrangements.**

Courts are suspicious of both, particularly topping fees.

(1) Break up fee

(i) If the deal tanks, then first bidder gets paid a share of the assets.

(2) Topping fee

(i) If 3rd party bidder over bids the initial bidder, bidder sometimes gets a share of the value.

2. Free and Clear Orders [363(f)]

i. Allow the trustee/DIP to sell Dr property free and clear of any interest in such property of an entity other than the estate (i.e., only buy assets, not liabilities).

a. EXA: DIP sales a division that makes guns. Court issues a "free and clear" order under 363(f) so that the buyer is receiving only the division, not any claims/liabilities against it. years later, a kid gets injured by a gun made by the division pre-petition. Can this injured plaintiff sue the new purchaser?

(1) Products liability exception for long-tail claimants on reorganization: **If a product is made by a company and somebody is injured by the product, new company operates as successor.**

(i) But courts are split as to whether new company will be liable b/c of 363(f).

K. Treatment of Undersecured Parties

1. Risk Premium on Interest Rate

i. If you're undersecured, you are entitled to a very small risk premium to reflect the fact that the Dr is in default.

a. But won't get your agreed to default rate, or the market rate.

2. Negative Amortization Plan

i. Situation: Dr can't pay unpaid principle and interest on time. So court folds the interest back into the principle and has the Dr pay it back over time.

Schechter doesn't like--court is basically gambling w/C's money b/c no guarantee Dr will be able to successfully reorganize.