TOPIC 21: BANKRUPTCY LAW

Overview

Bankruptcy is a federal body of law concerning the relationship between a debtor and creditors. Specifically, bankruptcy law provides several methods for a debtor to recover from financial situations that are overwhelming to the individual's continued well-being or existence. The bankruptcy process differs for individuals and businesses. This chapter introduces the bankruptcy system. It introduces the applicable bankruptcy laws and key provisions. It begins by explaining the types of bankruptcy — Chapters 7, 11, and 13. It then explains the method for initiating and processing a bankruptcy filing. It explores the role of the debtor, creditors, bankruptcy court, and trustee and the rights of each during the bankruptcy process. This includes the trustee or debtor in possession's right to stop collection efforts; the right to disaffirm contracts; the right to recover certain prior payments made to creditors, etc. A key concept throughout the bankruptcy process is the priority of secured and unsecured creditors. Lastly, it explains the rights and obligations of the parties at the conclusion of the bankruptcy process.

VIDEO LESSON - INTRODUCTION

VOCABULARY & CONCEPTS

TOPIC 21: BANKRUPTCY - QUESTIONS & ANSWERS

1. What is "bankruptcy"?

Bankruptcy is both a status and system of laws aimed at protecting individuals and businesses (collectively, "individual"). An individual is bankrupt when she is insolvent or the value of her debts exceeds the value of her assets. The bankruptcy system is a body of laws that allows for the elimination or restructuring of an individual's debt. The underlying objective of the system is to rehabilitate and allow for the future prosperity of the individual. The bankruptcy process is the subject of this chapter.

- ***Discussion***: How do you feel about the concept of allowing individuals to eliminate or restructure their debt? What affect do you think this ability has on economic activity and productivity in society? What arguments can you provide for and against this system?
- ***Resource Video***: http://thebusinessprofessor.com/what-is-bankruptcy/

2. What are the types of business bankruptcy?

The primary classifications for bankruptcy are as follows:

- *Liquidation* - Liquidation bankruptcy is the process by which the assets of an individual or business are liquidated or sold in an effort to generate funds to pay creditors. Any debts owed to creditors after the liquidation of assets and payment to creditors is discharged.
  - *Note*: "Discharge" of a debt means that the debt is erased and cannot be collected through legal means in the future. For individual debtors, some assets may be exempt from inclusion in the bankruptcy process.
  - *Example*: ABC Corp is suffering declining sales. The company debts exceed its assets and it cannot service all of its debts from its revenues. ABC Corp decides to file for liquidation bankruptcy, which involves selling off all of its assets and transferring the funds generated to creditors.
- *Reorganization* - A reorganization bankruptcy is a process by which the individual or business establish a plan to pay all secured debts and as much of its unsecured debts as possible during a set period of time (usual 5 years). The terms of the plan, including how much is paid to each creditor are based upon a number of factors, such as the amount of recurring, disposable income of the debtor. The unpaid portion of any unsecured debts are erased after the end of the payment plan period. The business may continue operations throughout this process.
  - *Note*: Creditors are paid based upon their "priority" and the status of their claims as secured or unsecured. Classes of investors receive a pro-rata share of available assets based upon the funds available and size of their claims. Secured creditors must be paid in full or a plan of reorganization fails.
  - *Example*: ABC Corp files for reorganization bankruptcy. All debt collections against the company halt. ABC must now come up with a plan to pay off its debts with income from future operations. It must use

all disposable income to pay debts for the plan period. Secured debtors must be paid in full before unsecured debtors receive any funds.

- *Voluntary vs Involuntary* - The bankruptcy process begins either with a debtor filing a voluntary petition or creditors of the debtor filing an involuntary petition. A debtor who qualifies under the law and wishes to do so may file a voluntary bankruptcy petition. In other situations, a creditor (or creditors) of a business debtor who meets the statutory requirements may force the debtor into involuntary bankruptcy. The process for initiating an involuntary bankruptcy is discussed separately.

While the process for liquidation bankruptcy is similar for individuals and businesses, reorganization bankruptcy for each is distinct. Throughout this chapter, we focus on business bankruptcy; however, many of the concepts applicable to business bankruptcy apply equally to individuals.

- ***Discussion***: Why do you think the law allows for both liquidation and reorganization bankruptcy? Are the objectives of each of these types of bankruptcy different? How do you feel about the ability to voluntary elect bankruptcy or to be forced into bankruptcy by a debtor?

- ***Practice Question***: ABC Corp is in financial trouble. It is considering filing for bankruptcy protection. Can you explain the two bankruptcy options available to ABC Corp and the general characteristics of each?

- ***Resource Video***: http://thebusinessprofessor.com/types-of-bankruptcy/

THE BANKRUPTCY PROCESS

3. Who are the primary participants in the bankruptcy process?

The primary participants in the bankruptcy process are as follows:

- *Debtor* - The debtor is the individual or business entity seeking or filing for bankruptcy protection.

- *Creditor* - A creditor is any individual owed a debt or obligation by the debtor. Creditors may include individuals, businesses (or other entities), or holders of securities (debt or ownership interests) of a business debtor.

    - *Note*: To be included in the bankruptcy process, creditors must receive notice of the bankruptcy filing.

- *Bankruptcy Trustee (or Debtor-in-Possession)* - The bankruptcy trustee is a representative elected (or appointed) to represent the interests of creditors of the bankrupt debtor. The trustee is charged with assembling the assets of the debtor's estate and either selling those assets or administering those assets in accordance with a plan of reorganization. The trustee must meet numerous statutory qualifications, including being independent and disinterested from the debtor or creditors. The role of the trustee varies a bit between personal and business bankruptcies and liquidation and reorganization bankruptcies.

    - *Note*: In Chapter 7 liquidation cases, the creditors may elect the trustee. In Chapter 13 reorganization cases, the US Attorney General may appoint a standing trustee to represent all creditors in the Chapter 13 case.

- *Personal & Business Liquidation Bankruptcy* - The trustee automatically takes control over the debtor's estate, liquidates the non-exempt assets, and distributes the proceeds to creditors. This process is the same in a personal and business liquidation.

- *Personal Reorganization Bankruptcy* - The trustee accounts for all of the assets of the debtor, assists in the development of a plan of reorganizations, and administers an approved plan for the reorganization of debts and payment of creditors.

- *Business Reorganization Bankruptcy* - Generally, a business debtor remains in possession of the assets of the bankruptcy estate. The debtor is known as a "debtor-in-possession" (DIP). The DIP serves the same function as the trustee but manages its assets and operations in accordance with the rules laid out by bankruptcy law. In this case, a trustee is only appointed when creditors of the estate petition the court to do so in an attempt to protect their interests. This normally happens when the debtor-in-possession fails to act in accordance with bankruptcy law or fails to otherwise adequately protect the interests of creditors.

• *Bankruptcy Court* - The bankruptcy court is a federal court charged with administering the bankruptcy process. Much of the bankruptcy process is handled by the trustee or debtor-in-possession. The court generally steps in to review and approve liquidations and plans of reorganization, grant discharges of indebtedness, and adjudicate disputes between or among debtors and creditors.

The role of each of these participants is discussed separately.

• ***Discussion***: Do you think the bankruptcy process protects the rights of debtor and creditors? Why or why not? Why do you think the role of the trustee is varied between business and personal reorganizations?

• ***Resource Video***: http://thebusinessprofessor.com/primary-participants-in-bankruptcy-process/

4. What key concepts are necessary to understand the bankruptcy process?

Below are some key concepts and definitions to understand prior to continuing with this chapter.

• *Filing for Bankruptcy* - Filing for bankruptcy means submitting a bankruptcy petition along with all supporting documents to the bankruptcy court. For individuals, a bankruptcy filing is voluntary (optional for the individual). A business bankruptcy may be voluntary or involuntary. In a voluntary petition, the bankruptcy court will review the initial filing for completeness. If accepted, the court will initiate the bankruptcy process. If applicable, the court will then forward the case to the office of the trustee. In a business reorganization, the debtor-in-possession will begin exercising the authority granted a trustee under the bankruptcy law. In an involuntary bankruptcy filing, the debtor has the option of agreeing with the petition or contesting the petition before the bankruptcy court.

• *Bankrupt Estate* - Upon filing bankruptcy, the court will issue an "order of relief". This order serves to form the bankruptcy estate. The bankruptcy estate includes all non-exempt assets and debts of the debtor at the time of the bankruptcy filing. Basically, the debts and assets of the debtor are held in trust and managed for the benefit of creditors. Assets acquired or debts incurred after the filing of bankruptcy may be excluded from the bankruptcy estate, absent a specific bankruptcy law allowing the estate to incur the debt or claim an interest in the asset.

  - *Note*: Bankruptcy law incorporates federal and state laws regarding assets that are exempt from the bankruptcy estate. This may include an equity value in a primary residence, a dollar value of specific types of personal property, retirement accounts, etc.

- *Automatic Stay* - The automatic stay is an important protection afforded a debtor and the bankruptcy estate. Once the court issues the order of relief, the law grants the debtor a stay from all collection efforts by creditors or their representatives. The stay of proceeding places penalties on any creditor who seeks to collect a debt incurred prior to the bankruptcy filing. This provision gives the debtor the ability to assemble debts and develop a plan for liquidation or reorganization.

- *Meeting of Creditors* - Once the order of relief is issued, creditors have the opportunity to meet to examine debtor records and discuss claims against the estate. This meeting is more common in business bankruptcies than in individual bankruptcies. In chapter 7 cases, the trustee will orchestrate the vote to elect a permanent trustee.

- *Creditor Priority* - Priority in bankruptcy refers to the order in which creditors of the debtor or bankruptcy estate are paid. Generally, secured creditors must be paid in full from the liquidation or reorganization, or the asset(s) securing the secured creditors' claims must be surrendered to them. Once secured creditors are paid, unsecured creditors are paid in their established order of priority. Unsecured debtors with similar priority are treated as a class. If each unsecured debtor in a class is not paid in full, each member of the class receives payment based upon an equal percentage of her debt. Creditor priority may be established by the nature or type of the debt, the timing or order in which the debt is incurred, or the contractual provisions associated with the debt. Generally, unsecured creditors only receive payment of a fraction of their total claim (if they receive anything at all) due to the scarcity of assets in the bankruptcy estate. For this reason, creditors often argue over their priority.

  - *Note*: The concept of priority is covered in greater detail in the chapter on secured transactions.

- *Discharge* - The debts of the debtor that are included in the bankruptcy estate are generally discharged after the successful completion of the bankruptcy process. This means that the debts are satisfied and the creditors cannot later seek repayment of these debts. Whatever amount the debtor receives as payment on the debt from the bankruptcy estate is final. The type of bankruptcy will determine whether a creditor receives a single payment (in a liquidation) or whether the debtor receives installment payments for a period of time (in a reorganization).

  - *Note*: Certain obligations cannot be discharged in bankruptcy, such as tax, alimony and child support obligations, intentional tort liability, student loan liability, breach of fiduciary duty, drunk driving liability, certain government fines, and debts not submitted to the trustee.

- ***Discussion***: Why do you think the debts and assets of the debtor are held in trust during the bankruptcy process? What do you think is the value of the automatic stay? How do you think priority rules affect the conduct of creditors when lending to debtors, if at all?

- ***Resource Video***: http://thebusinessprofessor.com/key-concepts-to-understand-bankruptcy-process/

5. What rules govern the bankruptcy process?

The rules governing the bankruptcy process are contained in Title 11 of the US Code of Statutes. The relevant sections of the bankruptcy code are organized as follows:

- Chapter 1 – General Provisions – Definitions, Powers of Court
- Chapter 3 – Case Administration
    - Note: Chapters 1, 3, and 5 are generally applicable to all bankruptcy cases
- Chapter 5 – Creditors and Claims
- Chapter 7 – Liquidation
- Chapter 9 – Municipal Bankruptcy
- Chapter 11 – Reorganization
- Chapter 13 – Individual Reorganization

Bankruptcy law is augmented by common law interpretation of statutes and regulations by federal bankruptcy courts. Further, state priority laws and exemptions are integrated into the bankruptcy process.

6. What is the authority of the bankruptcy court?

The bankruptcy court has authority to hear any case arising under the bankruptcy system. Generally, the role of the court is simply to approve a plan of liquidation or reorganization. The court's role expands when there is some level of dispute between debtor and creditor. In a dispute, the bankruptcy court does not allow for a jury trial. A bankruptcy judge, appointed pursuant to Article I of the US Constitution, is charged with hearing the case. Matters arising under the bankruptcy system commonly include administration of the bankruptcy estate, allowance of claims against the estate, counterclaims by the estate against claimants, exemptions of estate property, and matters relating to confirmation of a plan of reorganization. The court may also enter appropriate orders and judgments as provided for under the bankruptcy code.

- ***Discussion***: Why do you think the jurisdiction of the bankruptcy court is limited? Hint: Think about the constitutional authority of the bankruptcy court.
- ***Resource Video***: http://thebusinessprofessor.com/what-is-the-authority-of-the-bankruptcy-court/

7. What is the authority of the trustee (debtor in possession) in bankruptcy?

As previously discussed, the trustee in bankruptcy plays an important role in the administration of a bankruptcy case. The general authority of the trustee includes:

- affirming or disaffirm contracts with the debtor which are yet to be performed;
- setting aside fraudulent conveyances from the bankruptcy estate;
- voiding certain preferential transfers of property by the debtor to creditors;
- suing those who owe the debtor an obligation that is not paid; and
- setting aside statutory liens on property taking effect upon the filing of bankruptcy.

Remember, the trustee in bankruptcy plays a primary role in all individual bankruptcies and business liquidation bankruptcies. Trustees are only appointed in business reorganizations in limited circumstances. It is the responsibility of the DIP to administer the bankruptcy estate. The authority of the DIP is discussed separately.

- ***Discussion***: What do you think about the authority of the bankruptcy trustee? Why do you think the trustee's authority is so broad?
- ***Practice Question***: ABC Corp is in the process of a liquidation bankruptcy. A bankruptcy trustee has been appointed to control ABC's bankruptcy estate. What are the powers of the trustee in settling the debts and obligations of the estate?
- ***Resource Video***: http://thebusinessprofessor.com/role-of-trustee-in-bankruptcy/

8. What assets of the debtor are included in the bankruptcy estate?

The assets of the bankruptcy estate include all legal and equitable interests of the debtor in property at the commencement of the bankruptcy case. A legal interest means any legal right to the exclusive use and enjoyment of the property. An equitable interest includes any rights or claims to the ownership of property based upon principles of fairness. So, if a debtor has the ability to make a valid demand or claim for ownership rights in property, that property becomes part of the bankruptcy estate. This may include rights to sue or collect debts from others. Property of the estate also includes property that the debtor acquired within 180 days of filing for bankruptcy if acquired with proceeds or profits from property of the estate. Property excluded from the estate includes any income derived from the services of the debtor performed after the filing for bankruptcy protection, equitable powers that the debtor may exercise for others, educational IRA plans, 529 plans, and certain ERISA qualified retirement plans.

Federal bankruptcy law allows for certain exemptions of property from the estate based upon state law. State statutes regarding what constitutes a property interest of an individual is generally determinative of whether property indeed belongs to the debtor. Certain agreements will attempt to thwart the provisions of the bankruptcy code by limiting the transfer of property to debtors or divest debtors of ownership in property upon the filing of bankruptcy. These agreements are generally ineffective to prevent such property from becoming property of the bankruptcy estate.

- *Note*: An important state statute regarding exempt property from a bankruptcy estate regards the value of a homestead (or real property) exemption.

- ***Discussion***: How do you feel about the type of assets included in the bankruptcy estate? Why do you think certain assets are excluded from the estate? Why do you think the federal bankruptcy law follows state law with regard to the assets that are exempt from the bankruptcy estate? What effect might this have on a debtor's choices when filing for bankruptcy protection?

- ***Practice Question***: Doug is involved in a vehicle accident with Harry. Harry is driving a $1 million Lamborghini sports car. Harry sues Doug and receives a $1 million judgment. Doug has no other debts, but he decides to file for a chapter 7 liquidation bankruptcy. Doug's only assets are an educational IRA and his home, which is worth $500,000 and is not subject to a lien or security interest. How will Doug's bankruptcy filing affect Harry's claim against him? What will determine whether Harry receives any money for his claim against the bankruptcy estate?

- ***Resource Video***: http://thebusinessprofessor.com/what-assets-or-included-in-the-bankruptcy-estate/

9. What is the automatic stay in bankruptcy?

The automatic stay under Section 362 of the Bankruptcy Code protects debtors from ongoing collection efforts (during the pendency of the bankruptcy case) against property included in the bankruptcy estate. Specifically, creditors are prohibited from the following conduct:

- efforts to collect, assess, setoff, or recover a claim against a debtor arising before the bankruptcy filing;

- commencing or continuing a judicial, administrative, or other action to collect the debt;

- enforcing a judgment against the debtor's property;

- obtaining possession or control over assets included in the bankruptcy estate; or

- creating, recording, or enforcing a lien against the debtor's property.

Some limitations to the protections afforded under section 362 include:

- commencement or continuation of criminal actions and certain actions for domestic support;

- commencement or continuation of actions by governmental units pursuant to its regulatory power (such as tax liability); or

- creation or perfection of a statutory lien for certain types of real property.

The stay of proceeding will continue until the case is closed, dismissed, or discharge is granted. The court may also relieve or modify a stay generally or for a specific creditor for cause, for lack of adequate protection of a secured creditor's interest, or if the debtor has no equity in the subject property and it is not necessary for the reorganization of the debtor's estate. If a debtor violates a stay, any collection action can be undone. Further, if a debtor willfully violates the stay, the debtor may recover any attorney's fees incurred in challenging the collection action, as well as potential punitive damages.

- ***Discussion***: Why do you think the bankruptcy code provides the above-referenced protections under section 362? Are these protections adequate? Why or why not? Does the ability of the bankruptcy court to modify the 362 stay provision affect your opinion? Does this provision adequately protect debtor interests?

- ***Practice Question***: ABC Corp files for bankruptcy protection. 123 Corp is a debtor of ABC with a security interest filed in several pieces of ABC's equipment. 123 wants to understand its right to seek collection of the debt against ABC, including repossessing the equipment securing the debt. Can you explain the limitations on 123's ability?

- ***Resource Video***: http://thebusinessprofessor.com/section-362-automatic-stay-in-bankruptcy/

10. What is a claim by creditors of the bankruptcy estate?

A claim is a notice to the trustee of the debtor's estate that the debtor owes a fixed amount to the claimant. Claimants are creditors of the estate. For liquidation bankruptcies and personal reorganization bankruptcies, creditors of the estate must submit a proof of claim within a specific period of receiving notice of the bankruptcy filing. A creditor that fails to file a claim against the estate is barred from later collecting that debt if the bankruptcy filing proceeds to discharge of the debtor. Below are several important aspects about claims against the bankruptcy estate:

- *Proofs of Claim* - At the commencement of a bankruptcy case, the debtor is required to provide a list of all assets and debts to be included in the estate. The debtor must also identify all creditors holding these debts. Creditors are then given notice of the debtor's bankruptcy case with instructions on how to submit a claim. Creditors must then submit a proof of claim attesting to the court the nature and amount of the claim. If a creditor submits a secured claim, she must include evidence of a security interest. Creditors in Chapters 7 and 11 bankruptcies must file the proof of claim within 90 days of learning of the bankruptcy case. In Chapter 11 cases, the court will establish a "bar date" by which creditors may file a proof of claim; but, filing a proof of claim is not necessary to receive a distribution from the debtor's estate. All creditor claims are generally allowed, unless the claim is challenged by the debtor, trustee, debtor-in-possession or by other creditors.

    - *Note*: In some cases, unsecured creditors may request the court appoint a "creditor's committee" to represent their collective interests and communicate with the debtor in possession.

- *Disputing Proofs of Claims* - When a creditor submits a claim against the bankruptcy estate, other parties in interest (such as the debtor, trustee, DIP, or other creditors) can file an objection to the claim. If a third-party opposes the claim, this creates a "contested matter" which is adjudicated in a proceeding before the bankruptcy court. The objecting party must demonstrate that the claim is not valid. If the party presents some evidence against the claim, the claimant will have to introduce evidence to support her claim. A trustee or debtor in possession generally pays based upon the amount of claim "allowed" by court.

- *Secured and Unsecured Claims* - A secured claim is the amount of a debt equal to the "value" of creditor's interest in assets of the estate. The claim is bifurcated and is secured to extent of the value of the collateral. Any amount of the creditor's claim beyond the value of the collateral is classified as an unsecured claim. The amount of a claim is generally the debt owed at the time of filing, including all amounts that accrue pre-petition, interest, late charges and attorney's fees. A debt generally does not receive interest during the pendency of the bankruptcy without special exception. Debts arising after the filing of bankruptcy are not included in the bankruptcy estate. The only post-petition debts included in the bankruptcy estate are the administrative expenses of managing the estate or instances of post-petition financing. These claims generally receive administrative priority over the unsecured claims. The difference between the allowed claim amount paid to the creditor and the amount of the creditor's claim is the amount of the debt discharged in bankruptcy.

- *Note*: To be included as part of a secured or unsecured claim, attorney's fees must be permitted by contract or state law. If so allowed, attorney's fees are treated the same as interest on the debt.

- ***Discussion***: What do you think about the requirement for all creditors of the debtor to submit claims to the bankruptcy estate? Is the requirement to dispute claims adequate? Do you agree with the manner in which secured and unsecured claims are handled?

- ***Practice Question***: ABC Corp files for Chapter 11 bankruptcy (reorganization). 123 Corp is a creditor of ABC. ABC sends notice of the bankruptcy filing to all creditors. What are the requirements for 123 to be paid on its claim? What happens if ABC or any other creditor disputes 123's claim against the estate? If the debt owed to 123 is secured by collateral that is only worth one half of the amount of the debt, how will this be handled?

- ***Resource Video***: http://thebusinessprofessor.com/proof-of-claims-in-bankruptcy-case/

11. What is voluntary and involuntary bankruptcy?

A bankruptcy case begins when either a debtor voluntarily files for bankruptcy or creditors petition to subject a business debtor to bankruptcy.

- *Voluntary Bankruptcy* - Any business may voluntarily file for a liquidation or reorganization bankruptcy at any time. While a liquidation bankruptcy causes a business to dissolve, a reorganization bankruptcy allows a business to continue operating. For an individual to file for reorganization bankruptcy under Chapter 13, she must have regular income and have unsecured debts not exceeding $307,675 and secured debts of less than $922,975. The requirements for a business to undertake a reorganization bankruptcy under Chapter 11 are discussed in greater detail below. In a liquidation bankruptcy under Chapter 7, the primary limitation is that an individual (not a business) must meet a "means test". The means test limits the ability of individuals to file for bankruptcy if the individual has recurring revenue (income) above a certain amount. The amount is determined by the state's median income for its citizens. The purpose of this test is to prevent individuals who have sufficient income to pay debts from using a liquidation bankruptcy to wipe away debts and defraud creditors.

    - *Note*: The means test does not apply to business liquidations. A business may file for liquidation bankruptcy at any time.

- *Involuntary Bankruptcy* - An involuntary bankruptcy, as the name implies, is involuntarily imposed upon the debtor. One or more creditors of a business debtor may commence an involuntary bankruptcy action against a debtor by filing a chapter 7 or chapter 11 petition with the bankruptcy court. To commence this action, the following conditions must be present:

    - three or more business creditors must have good faith, non-contingent claims against the debtor totaling

$15,325 or more (beyond the amount of any secured debt), or

- if the debtor has fewer than 12 creditors, a single creditor holding a good faith, non-contingent claim against the debtor of $15,325 or more.

These provisions are in place to make certain that no single creditor can undermine a business's operations by petitioning for involuntary bankruptcy without meeting minimum standards. The court may award damages against a creditor for filing an involuntary bankruptcy in bad faith. If the debtor fails to successfully defend a petition for involuntary bankruptcy, the court will order relief against the debtor. If the debtor contests the involuntary filing, the court will only subject the debtor to bankruptcy if:

- The debtor is not paying its debts as they come due, or

- Within 120 days prior to filing the action, the court appoints a custodian over the assets of the debtor with the purpose of enforcing a lien.

It is important to remember that any debts that the debtor fails to pay in a timely manner must be good faith debts that are not subject to dispute or controversy. The danger for a creditor seeking to place the debtor in involuntary bankruptcy is, if the court dismisses the action (other than pursuant to agreement of all parties), the court may award court costs and attorney's fees against the creditor. If the creditor acted in bad faith, she may be subject to actual damages suffered by the debtor, as well as punitive damages.

- ***Discussion***: What do you think about the unlimited ability for businesses to file a voluntary bankruptcy? What do you think about the ability of creditors to force a debtor into involuntary bankruptcy? Are the requirements for an involuntary bankruptcy sufficient to protect a debtor? Why or why not? Do they offer a valid option for creditors in enforcing debts against a debtor? Why or why not? Does the ability of the creditor to receive damages for a bad-faith, involuntary filing affect your opinion?

- ***Practice Question***: ABC Corp is a large corporation that produces farm chemicals. ABC owes over $1 million to 123 Corp for services rendered and supplies. ABC has continuously failed to respond to 123's collection efforts. ABC Corp does not seem to have outstanding debts owed to any other businesses. What are 123s options to collect this debt through the bankruptcy process?

- ***Resource Video***: http://thebusinessprofessor.com/voluntary-and-involuntary-bankruptcy-requirements/

CHAPTER 7 and CHAPTER 11 BANKRUPTCY

12. What is the "Chapter 7" bankruptcy process?

The Chapter 7 bankruptcy process is fairly straightforward. It involves the following steps:

- *Filing* - The debtor files a voluntary petition or is the subject of an involuntary petition.

- *Bankruptcy Estate* - Initiating the bankruptcy process creates the bankruptcy estate containing all of the debtor's non-exempt assets. Also, the automatic stay halts all collection efforts against the debtor. The trustee in bankruptcy is appointed or elected and charged with identifying and assembling assets of the bankruptcy estate.

- *Proofs of Claim* - At the time of filing, creditors of the debtor are put on notice of their rights to put in a claim against the bankruptcy estate for any debts owed them by the debtor. Secured creditors must be paid in full from the estate or have the property serving as collateral for the debt surrendered to them. Once secured creditors are paid to the extent of the value of their security interest in collateral, unsecured creditors are paid based upon their priority. Higher priority creditors will be paid before lower priority creditors. All creditors in a given class of debtor will be paid an equal percentage of their claims.

- *Liquidation* - The trustee will sell or liquidate all available assets of the bankruptcy estate to generate funds to pay estate debts.

- *Discharge* - Once all assets of the estate are liquidated and creditors paid, the court will enter an order discharging the debtor of all debts identified in the bankruptcy proceeding. Failure to submit a claim after receiving notice will cause a claim to be discharged. If a creditor is not notified of the bankruptcy proceeding, that creditor's claim against the debtor will not be discharged.

This process is fairly linear in nature. It is common for bankruptcy cases to be dismissed at any stage of the proceeding for failing to move forward in accordance with the court's order.

- ***Discussion***: What do you think about the process for filing a Chapter 7 Bankruptcy? Can you think of situations where a business liquidation could be very difficult? Do you think the process adequately protects creditor rights?

- ***Practice Question***: ABC Corp is in dire straits. It is considering filing for bankruptcy and liquidating the company. Can you explain to ABC the process of liquidating under Chapter 7?

- ***Resource Video***: http://thebusinessprofessor.com/chapter-7-bankruptcy-process/

13. What is the Chapter 11 bankruptcy process?

Chapter 11 bankruptcy (Chapter 11) seeks to reorganize or restructure the debts of the debtor without liquidating all of the debtor's assets (as under Chapter 7). The objective is to allow the business to continue operations in an attempt to maximize the value of the business to all stakeholders. Chapter 11 follows a similar process to that of Chapter 7, with the following notable differences:

- *Bankruptcy Estate* - Filing for bankruptcy protection creates the bankruptcy estate. At this point, the court does not appoint a bankruptcy trustee to collect and manage the assets of the estate. Rather, the debtor remains in control of the business operations and all business assets. The DIP is vested with the same authority as a trustee in a Chapter 7 bankruptcy. This includes authority to use or even sell assets for the benefit of the estate, accept or reject contacts, and seek post-petition financing for the business. All of this authority is limited, however, by the objective of the DIP to control the estate for the benefit of all creditors.

    - *Note*: The debtor in possession's duty to creditors is a change from the board's duty to manage the corporation for the benefit of creditors.

- *Proof of Claims* - A creditor of the bankruptcy estate is generally not required to submit a proof of claim. Rather, the DIP is required to account for and identify all debts of the estate. The DIP must give all creditors notice of the bankruptcy filing. Secured creditors may be concerned by the DIP's use of the collateral securing their claim in the continued operations of the business. If so, they can challenge DIP actions in the bankruptcy court. Unsecured creditors may organize and request the bankruptcy court recognize the group as a creditors committee. The purpose of the creditors committee is to represent the interests of all creditors in negotiations with the DIP.

- *Plan of Reorganization* - The DIP must put forward a plan of reorganization. This plan must pay off all secured creditors within the term of the plan. Further, the plan must be voted upon and accepted by at least one class of "impaired" unsecured creditors under the plan that is not paid in full. Lastly, the bankruptcy court must approve the plan. If the plan is not reasonable or the DIP cannot possibly achieve these objectives, the plan may fail and the bankruptcy case could be dismissed.

    - *Note*: In many cases, the company will achieve creditor approval of a plan by forcing the plan on certain groups of creditors. This is known as a "cramdown".

Filing for bankruptcy protection under Chapter 11 can be a useful tool for business. As such, businesses have developed special purpose bankruptcies to achieve a specific business objective. For example, a business may use chapter 11 to escape certain types of tort liability. Further, if a company has a single prevailing asset, a company may liquidate the large asset, but otherwise go through the chapter 11 process. This is common when the debtor has a large single real estate asset.

- ***Discussion***: Why do you think the Chapter 11 bankruptcy process allows the debtor to remain in control of business assets? Why do you think this is of primary concern to secured creditors? Do you think it protects creditor rights to require that a bankruptcy plan be approved by certain classes of unsecured creditor? Why or why not?

- ***Practice Question***: ABC Corp is in dire straits. It is considering filing for bankruptcy to reorganize the company's business operations. Can you explain to ABC the process of liquidating under Chapter 11?

- ***Resource Video***: http://thebusinessprofessor.com/chapter-11-bankruptcy-process/

14. What is the authority of the debtor in possession?

The authority of the debtor in possession (DIP) is similar to that of a bankruptcy trustee. The objective of the DIP is to guard the interests of creditors by reshaping the bankruptcy estate to allow the business to continue operations. In doing so, the DIP is vested with the following important powers.

- *Accept or Reject Contracts* - The DIP may accept or reject contracts of the debtor that have not yet been performed or are on-going. In this way, the DIP can get rid of contracts that are oppressive or cause losses to the business but can retain contracts that are beneficial and necessary for the reorganization of the business. This rule invalidates provisions in a contract restricting, conditioning, or prohibiting a debtor's rights to assign a contract. To retain or assume a contract, the DIP must provide adequate assurance of continued performance and must cure any defaults under the contract. The court may impose timelines and restrictions on the termination or any modifications to existing contracts. Further, there may be limitations on the ability of the debtor to later assign an assumed contract (such as a requirement for assurance of future performance). Lastly, any contract that has been terminated pre-petition may not be assumed in bankruptcy.

- ***Discussion***: Why do you think the bankruptcy law allows a DIP to accept or reject executory contracts of the debtor? Do you think it is fair to contract parties that the DIP can accept beneficial contracts and reject non-beneficial contracts? Is requiring the DIP to provide adequate assurance of performance sufficient to protect the rights of parties to retained contracts?

- ***Practice Question***: ABC Corp is suffering a decline in business and cannot meet its obligations. ABC decides to declare Chapter 11 bankruptcy. As a DIP, ABC seeks to reject several contracts that are causing losses and retain several contracts that are beneficial to the business. What rules apply to ABC's plan?

- ***Resource Video***: http://thebusinessprofessor.com/debtor-in-possession-authority-to-accept-or-reject-contracts/

- *Avoiding Powers* - The DIP exercises the avoiding powers of a bankruptcy trustee. This is known as the "strong-arm" powers. The strong-arm authority allows the DIP to:

  - *Avoid Preferential Conveyances* - The DIP may seek to undo any preferential conveyances or payments made by the company and certain statutory liens placed on the debtor's assets by creditors. Generally, a payment is considered preferential if it made while the debtor was insolvent and it enables the recipient creditor to receive more than such creditor would receive if the case were a case under Chapter 7. Further, a preferential conveyance must meet the following elements:

    - any transfer of interest in the debtor's property;

    - within 90 days of filing for bankruptcy (or one year if the transfer is to insiders of the business);

    - to or for benefit of a creditor on account of an existing debt.

    If these elements are present, the DIP may undo the transaction by making a claim against the preferred creditor for return of the transferred assets. There is an assumption that a debtor is insolvent in the 90-day period prior to the filing of bankruptcy. This period is extended to one year if any payment benefits an insider of the business (such as an owner of the business, officer, director, third-party guarantor, etc.). The longer time period for insiders rests upon the presumption that companies may siphon off funds to insiders upon signs of financial distress. The term "transfer" is broadly defined to include any payment, transfer of property, creation of a lien on property, or recording of a security interest. The requirement that the transfer benefit the creditor is also construed very broadly. Even a payment on a debt that somehow reduces a third-party guarantor's liability for the debt may be considered preferential.

    There are several exceptions or defenses that protect conveyances that may otherwise qualify as preferential, including:

- *Contemporaneous Exchanges of Value* - This exception allows a debtor to make payment to a creditor who simultaneously provides value to the debtor. The theory behind this exemption is that a supplier should not worry about creating an "antecedent debt" based upon the timing of the exchange of money (or property) for goods or services.

    - *Example*: A business could purchase goods or hire services and make immediate payment for those goods or services without payment being considered preferential.

- *Payment in the Ordinary Course of Business* - If a payment is recurring or is part of the ordinary course of the employer's business, it may not be deemed preferential. To determine if such a payment is truly in the ordinary course of business, a court will examine the length of account, relationship history, whether the amount or form was different from past payment, any unusual collection or payment activity, and whether creditor took advantage of debtor's deteriorating financial condition.

    - *Example*: A recurring financing payment made each month on assets or recurring services would not be considered a preferential payment.

- *Purchase Money for Collateral* - A transaction that creates a security interest in property acquired by the debtor will not be considered preferential if done pursuant to a security agreement that describes the collateral and is given to allow the debtor to purchase the collateral. Generally, the debtor must file the security interest within 20 days of taking receipt of the collateral or the security interest loses priority to other secured creditors.

    - *Example*: The debtor purchases equipment from a dealer who finances the deal. If the dealer takes a security interest in the equipment within 20 days, the security interest is not deemed to be a preferential payment.

- *Enabling Loans* - If a debtor receives an enabling loan to continue operations, payments on that loan may not be considered preferential.

    - *Example*: A debtor receives funds on a new line of credit. Payment on this credit agreement is not considered preferential.

- *Extending New Value* - If a debtor makes payment to a creditor on account or existing debt, but later receives new value in a transaction (such as an extension of credit or purchasing goods on account), that payment or any lien taken on goods or payment made toward those goods or services would not be preferential.

    - *Example*: The debtor owes a seller of inventory who finances the sale to the debtor. If the debtor makes a payment on the debt in order to receive new inventory financing, this would not be considered preferential.

- *Floating Liens* - If a debtor acquires and finances new assets or is subject to a prior lien specifically covering after-acquired collateral (such as inventory or receivables), the attachment of a floating lien will not be considered preferential. An important limitation with this defense is that the creditor cannot materially improve her position as a result of any payment.

- *Note*: Inventory and receivables financiers are protected when the debtor acquires property, but they are not permitted to enhance their positions during the 90-day period.

- *Example*: Fred makes a loan to ABC Corp. The loan is secured by all of ABC's assets and includes an after-acquired property clause. If ABC acquires new property, it will be subject to Fred's security interest. The attachment of this floating lien to the newly acquired equipment is generally not considered a preferential payment.

- *Avoid Fraudulent Conveyances* - The Bankruptcy Code allows for state fraudulent-transfer laws to remain in effect during a bankruptcy. The bankruptcy code allows the DIP to reclaim any fraudulent conveyances by the debtor. The DIP may look back two years to challenge any fraudulent transfers made with the "intent to hinder, delay or defraud" creditors, or made without "reasonably equivalent value". A failure of reasonably equivalent value may include situations where a debtor transfers corporate assets to a creditor or purchaser for an extremely low value.

  - *Example*: ABC Corp transfers assets to the CEO's brother-in-law for one-tenth of the value of the assets. If ABC files for bankruptcy within two years of this transaction, the DIP would likely be able to recover the assets (or equivalent value) as a fraudulent transfer.

If the DIP successfully challenges and avoids a transfer, she may recover the actual property transferred or the value of the property transferred. There are limits on the ability of the trustee to recover from a transferee who receives the property in exchange for value (such as payment of a preceding debt) and in good faith without knowledge of the voidability of the transfer.

- ***Discussion***: Why do you think the bankruptcy law allows a DIP to avoid preferential and fraudulent transfers by the debtor? How do you feel about the default position that a transfer within 90 days of bankruptcy filing is a preferential payment? What do you think about the exemptions of certain types of otherwise preferential payments? Are there any exceptions you would add or exclude? Why? How do you feel about the 2-year look-back period for fraudulent transfers?

- ***Practice Question***: Martin is CEO of ABC Corp. ABC is going through financial problems and files for Chapter 11 bankruptcy. Two months before filing for bankruptcy, Martin directed ABC to repay an outstanding debt owed to 123 Corp. 123 Corp is owned by a close friend of Martin. Under what provisions might a DIP challenge this transfer?

- ***Resource Video***: http://thebusinessprofessor.com/avoiding-powers-of-debtor-in-possession/

- *Stay of Proceedings* - The DIP may enforce or employ the Section 362 stay of proceeding provisions against existing debtors. This broad authority gives the DIP power to continue operations with existing creditors without being subjected to debt-collection practices that may thwart the reorganization of the estate. The DIP's authority trumps any rights to collection or agreement not to contest a debt that is present in the debt agreement. Upon request of a party in interest and after notice and a hearing, the court may grant relief from the stay. The justifications for relieving the stay are as follows:

- *No Equity in Property* - The debtor does not have any equity in the property and it is not necessary for an effective reorganization; or
  - *Example*: The debtor purchases equipment that is financed by the seller. At the time of filing bankruptcy, the debtor owes more on the loan than the equipment is worth. The equipment is not necessary for the continued operations of business, so the creditor may seek relief from the stay to repossess the equipment and sell it.
- *For Cause* - The court may relieve the stay of proceeding for cause, including the lack of adequate protection of an interest in property.

The primary limitations of the automatic stay are that it does not stop certain criminal actions, paternity suits, collection of domestic support obligations, or actions by a governmental unit exercising its police and regulatory power. The police or regulatory power exception should be narrowly construed when the actions result in financial penalty or forfeiture. Courts generally employ two tests to determine whether the stay should apply in these situations:

- *Pecuniary Purpose Test* - If the primary purpose of the government unit's action looks back and punishes for past conduct, it should not be excepted from the stay as an exercise of police or regulatory power.
- *Public Policy Test* - If the primary purpose of government action relates to stopping a continued threat to public safety or health, it should be excepted from stay as police or regulatory power.

One factor that the court will consider is whether relieving the stay would cause irreparable harm to the bankruptcy rehabilitative process.

- ***Discussion***: Why do you think the bankruptcy law allows a DIP to selectively enforce the Section 362 stay of proceedings? Do you think a creditor should be able to petition for the removal of the stay under the above-referenced situations? How do you feel about the application of the stay to certain police or regulatory powers of government agencies? Do the above-referenced tests for making this determination affect your opinion?
- ***Practice Question***: ABC Corp files for Chapter 11 Bankruptcy. The DIP issues notice to all debtors of the corporation to halt any collection efforts. Several secured creditors are concerned about their interest. Under what grounds can these creditors seek a lift for stay from the bankruptcy court?
- ***Resource Video***: http://thebusinessprofessor.com/automatic-stay-of-proceedings-in-bankruptcy/

- *Use of Business Assets* - The DIP may use assets of the business in on-going operations. This includes the use of business cash in the "ordinary course of business". This authority also includes using, selling, or leasing the business's assets. If an asset will be "permanently impaired" or the use of assets is challenged by a creditor of the estate, the court must specifically approve its use. Special issues arise when the DIP seeks to lease or sell business assets in the course of business. Physical assets of the business generally serve as collateral for one or more classes of secured creditor. In this situation, the secured creditors may demand adequate protection of their interests from the DIP. This means the DIP may have to take measures to ensure that the bankruptcy estate's use of the assets in on-going operations does not prejudice the secured status of the creditors. Adequate protection may be provided by:

- *Payments* - The DIP may make payments to the secured creditor for any decrease in the value of collateral securing the debt.

- *Second Lien* - The DIP may authorize an additional or replacement lien to the extent of any decrease in the value of collateral securing the debt.

- *Other Relief* - The DIP may provide other relief that provides the creditor with assurance of payment of the equivalent value of the collateral.

Also, to the extent of any surplus value in the collateral, the secured creditor is entitled to interest and reimbursement of attorneys' fees and expenses as part of its claim against the bankruptcy estate.

- ***Discussion***: Why do you think the bankruptcy law allows a DIP to use assets of the business to fund on-going operations? Do you think the above-listed methods of providing adequate assurance sufficiently protects creditor rights? Why or why not?

- ***Practice Question***: ABC Corp files for Chapter 11 Bankruptcy. The DIP continues to use business assets in the on-going operations of the business. Some of the assets are collateral for loans. The secured parties are concerned, as these assets will be used up in business operations. The secured parties do not want to be reduced to unsecured status. What is the DIP required to do in order to continue using these expendable assets in the course of operations?

- ***Resource Video***: http://thebusinessprofessor.com/authority-of-debtor-in-possession-to-use-business-assets/

• *Post-Petition Financing* - The DIP may establish unsecured credit (incur debts) in the ordinary course of business following the filing of bankruptcy. This practice creates new obligations for the bankruptcy estate that are often superior or have priority over payment of the existing debts. This is known as "administrative expense priority". These debts must be actual, necessary costs and expenses of preserving the estate. This ability is limited by the rule that an equity owner in the business cannot retain any value in a Chapter 11 bankruptcy until all other creditors are paid. The court may, however, grant an exception when a current shareholder extends new credit to the bankruptcy estate. While authority to secure post-petition financing is extremely important in reorganizing the bankruptcy estate, it can have a detrimental impact on existing shareholders who lose priority in favor of the post-petition creditors. If the DIP is unable to obtain credit, even with the promise of administrative expense priority, the court may, after notice and hearing, order:

- *Super-priority Administrative Expense* - This provides the creditor with priority over any or all administrative expenses of the kind.

- *Lien on Unencumbered Property of the Estate* - This provides the creditor with a lien on property of the estate that is not otherwise subject to a lien.

- *Junior Lien on Encumbered Property of the Estate* - This provides the creditor with a junior lien on property of the estate that is subject to a lien.

The court may only authorize a junior lien on encumbered property if the DIP is unable to otherwise obtain such credit and there is adequate protection of the senior lien holder.

- ***Discussion***: Why do you think the bankruptcy law allows a DIP to seek post-petition financing? Is it fair that post-petition debt receives administrative expense priority? Why or why not? Are the measures that a court may take to allow the DIP to obtain new financing fair to existing debtors? Why or why not?

- ***Practice Question***: ABC Corp files for Chapter 11 Bankruptcy. The DIP continues business operations. She realizes that the business will require new capital. What are her options for obtaining post-petition financing and the benefits she can offer to creditors? If she is unable to obtain financing by this method, what methods may a court employ to provide financing for the business?

- ***Resource Video***: http://thebusinessprofessor.com/authority-of-debtor-in-possession-to-secure-post-petition-financing/

15. What is appointment of a trustee or examiner?

In certain circumstances, the bankruptcy court will appoint a bankruptcy trustee to supervise the actions or conduct of the debtor in possession (DIP). Generally, however, there is a strong presumption against appointment of a trustee. To overcome this presumption, creditors must show “cause” why the appointment is necessary. Cause includes situations involving fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case. The bankruptcy court will look at the “totality of the circumstances” to determine the need for a trustee. An alternative to appointing a trustee is the appointment of a “corporate examiner”. The examiner serves a role similar to special counsel to the DIP. This action allows management to continue running the business while having activities monitored by the examiner.

- ***Discussion***: How do you feel about the DIP remaining in control of the business? Do you think appointment of a trustee should require a showing of “cause”? Why or why not? Do you think the appointment of a corporate examiner is sufficient protection to substitute for appointment of a trustee? Why?

- ***Practice Question***: ABC Corp files for Chapter 11 Bankruptcy. The DIP continues business operations. Many creditors become concerned about their interest based upon the DIP’s decision making and apparent incompetence. What are the options available to the creditors in this situation?

- ***Resource Video***: http://thebusinessprofessor.com/appointment-of-trustee-of-examiner-in-chapter-11-bankruptcy/

16. What is a plan of reorganization?

The DIB has an exclusive 120-day period to file plan of reorganization. The court may enlarge or reduce the exclusivity period "for cause". The DIB has exclusive control over the case early on and may take a first stab at the terms of the proposed restructuring. The bankruptcy code provides guidelines for the contents of the plan of reorganization as follows:

- *Mandatory Provisions* - The mandatory provisions to include a plan are as follows:
  - *Classes of Claims* - The plan must designate classes of claims.
  - *Equal Treatment* - All members of a class must be treated the same.
  - *Secured Claims* - Secured claims must be classified separately unless the creditors have common rights.
  - *Unimpaired Classes* - The plan must designate any class that is not impaired, any class that is impaired.
  - *Plan of Implementation* - The plan must provide adequate means for a plan's implementation.
- *Permissive Provisions* - The plan of reorganization may include any of the following provisions:
  - *Impair a Class* - The plan may impair any class.
  - *Executory Contracts* - The plan may provide for assumption or rejection of executory contracts.
  - *Sale of Property* - The plan may provide for sale of estate assets.
  - *Handling Claims* - The plan may provide for settlement or adjustment of claims belonging to the estate, such as turnover of property or avoidance claims.
  - *Other Provisions* - The plan may contain any other provisions that do not conflict with the reorganization of the estate.
- *Notice of the Plan* - Before the plan can be distributed to creditors and interest holders, the court must approve a disclosure statement for distribution. The disclosure statement must contain adequate information about the debtor and the bankruptcy filing. This generally includes:
  - description of debtor's business,
  - history of debtor's business,
  - current financial information, including the financial statements,

- description of plan and execution game plan,
- liquidation analysis,
- management retention and compensation,
- pro forma operations projections,
- summary of pending or planned litigation,
- transactions with insiders, and
- tax consequences if plan is confirmed.

Once the disclosure statement is approved by the court, the DIP may solicit acceptances from creditors and interest holders. The DIP must send the plan, disclosure statement, and ballot to all known creditors and parties in interest.

- *Acceptance of the Plan* - To approve the plan, a class of impaired creditor must accept the plan and it must be approved by the court. A class of creditors accepts the plan if approved by at least two-thirds (2/3) of the total claims and one-half (1/2) of the total of allowed claims of the class. "Unimpaired" classes of creditor are not entitled to vote on the plan. An unimpaired creditor will receive full payment of its claim under the plan. It is conclusively presumed that unimpaired creditors accept a proposed plan. If a class receives no dividend under the plan (no payment), it is deemed to have rejected the plan. Once approved by a single class of impaired creditors, the bankruptcy court must hold a hearing to determine whether the plan can be confirmed. The plan must meet the following elements for court approval:
    - *Best Interest* - The plan must be in the best interest of creditors. Dissenting creditors often litigate this element. Each creditor must receive at least as much as it would receive under a Chapter 7 liquidation.
    - *Administrative Priority* - Unless otherwise agreed, holders of administrative expense priority must be paid in cash on the effective date of the plan.
    - *Priority Claims* - Holders of priority claims must be paid by the effective date unless such class has accepted the plan stating otherwise.
    - *Feasible* - The plan must be "feasible", such that it is not likely to be followed by liquidation or further reorganization unless such course of action is proposed as part of the plan. Factors to determine whether a plan is feasible include:
        - earning power of the business,
        - adequacy of the capital structure,
        - economic and market conditions,

- ability and retention of management, and
- ability to meet obligations as they become due.

- ***Discussion***: What do you think about the process for proposing and approving a Chapter 11 bankruptcy plan? Why do you think the plan only requires approval of one class of impaired creditors? Should impaired creditors be given a vote? Why or why not? Do you think the rules required for confirmation of the plan adequately protect creditor interest? Why or why not?
- ***Practice Question***: ABC Corp files for Chapter 11 Bankruptcy. The DIP puts forward a plan for reorganization of the company. What is required for the plan to be approved by creditors? What is required for the plan to be approved by the bankruptcy court?
- ***Resource Video***: http://thebusinessprofessor.com/bankruptcy-plan-of-reorganization/

17. What is "cramdown" of a reorganization plan?

The plan of reorganization must be approved by at least one class of impaired creditor, excluding votes cast by corporate insiders. If any class of impaired creditor has not accepted the plan, the court, on request of the proponent of the plan, shall confirm the plan "if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class . . . [t]hat is impaired under, and has not accepted, the plan". This is known as "cramdown", as the plan is being forced upon impaired creditors who voted against plan approval. In the event of a cramdown, the court will determine whether treatment of each class is "fair and equitable". Even in a cramdown, the following attributes of the plan must be true:

- *Secured Creditors* – Secured creditors must retain a lien on collateral or proceeds and receive deferred cash payments equal to present value of the collateral or receive the indubitable equivalent of its claim.
- *Unsecured Creditors* – Unsecured creditors must be paid in full or no holders of junior claims may receive any payment.

- ***Discussion***: How do you feel about the ability of the court to cram down a plan on impaired creditors? What factors should the court use to determine whether the plan is fair and equitable to the impaired creditors?
- ***Practice Question***: ABC Corp files for Chapter 11 bankruptcy. The DIP puts forward a plan of reorganization. Under the plan, several classes of creditors will not receive full payment of their claims. That is, these creditors are impaired. If any of the impaired creditors object to the plan, what options are available to the DIP to seek creditor approval of the plan?
- ***Resource Video***: http://thebusinessprofessor.com/cramdown-of-chapter-11-bankruptcy-plan/

18. To what extent does the bankruptcy process relieve a debtor's debts?

Unless otherwise stated, confirmation of the debtor in possession's (DIP's) plan of reorganization discharges the debtor from any debt that arose before the date of the plan's final confirmation. The plan will specifically identify any post-petition debts that are not a part of the bankruptcy estate. If a creditor with a pre-petition debt fails to file a proof of claim, its debt will also be discharged as part of the bankruptcy process. Due process rights limit the ability of the court to discharge debts of claimants who did not receive notice of the bankruptcy filing. Unless otherwise indicated in the plan, confirmation vests all of the property of the estate in the debtor free and clear of all liens and encumbrances. Following plan confirmation, the debtor is in complete control of the business and able to continue operations.

- *Note*: In Chapter 11 reorganizations, a debtor is not required to submit a proof of claim. As such, failure to file the proof of claim will not result in discharge of the claim against the debtor.

- ***Discussion***: How do you feel about the ability of bankruptcy court to discharge debts of the debtor that were not presented as claims to the trustee? Is it fair to require the creditors to file a proof of claim in order to preserve their creditor status? Why do you think this rule does not apply in Chapter 11 reorganizations?

- ***Practice Question***: ABC Corp files for bankruptcy. It initially puts in a petition for Chapter 11, but later converts the filing to a Chapter 7 liquidation. ABC notified all creditors of the Chapter 11 filing, but failed to notify 123 Corp of the Chapter 7 filing. If 123 Corp fails to submit a proof of claim to the bankruptcy trustee, how will this affect 123's rights?

- ***Resource Video***: http://thebusinessprofessor.com/discharge-of-debtor-in-bankruptcy/