BANKRUPTCY LAW NEWSLETTER

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FINAL EXAM

[Editor's Note: An informal survey reveals that many lawyers suffer from the "school dream." That's the one where you find yourself in a final exam for a class you've never attended. For those who so suffer, we apologize for making your nightmare a reality. On the other hand, we thought it would be interesting to print a recent exam given by Bob Mollhagen to his Bankruptcy Workshop students at Cooley Law School. (Due to space limitations, Part A of the exam is not included.) Try your hand at the exam. Answers in this space in a later Newsletter.]

Thomas M. Cooley Law School

Bankruptcy Workshop
(Corporate Reorganizations)

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PART B

Adequate Protection/Relief from Stay Problem

Below is the Adequate Protection/Relief from Stay Problem followed by 4 questions. The questions refer to the problem. You should answer each question. Each answer is worth the possible points indicated. Keep your answers short. Lengthy answers will be discounted.

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Problem

United Corporation filed a Chapter 11 petition on April 1, 1991. Assume the following facts (amounts owed are as of April 1, 1991, unless otherwise indicated):

* United owes $300,000 to Friendly Bank secured by a first priority, properly perfected security interest in inventory, accounts receivable and proceeds. United currently has $100,000 of accounts receivable ($50,000 of which has been generated in the two week period before filing), $100,000 of inventory and cash proceeds of accounts receivable of $150,000 in an account at Second Bank.

* United owes Associated Lenders $500,000 secured by a first priority, properly perfected security interest in all United machinery and equipment, including after-acquired property. A UCC-1 was properly filed on April 15, 1986. The collateral has a 10 year remaining useful life with no salvage value. All of United's machinery and equipment is valued at $600,000 (in place-going concern) and $520,000 (commercially reasonable liquidation).

* The Internal Revenue Service filed a Federal Tax Lien on February 1, 1991 in the Secretary of State UCC Division records for $75,000 for payroll taxes.

* United owes Allied Equipment Dealers $100,000 on a note in an original amount of $150,000 which was borrowed to purchase a milling machine for use in United's manufacturing operations. On May 1, 1988, 15 days after United purchased and took possession of the milling machine, Allied properly perfected its

security interest in the milling machine. The milling machine is valued at $120,000 (commercially reasonable liquidation) and $90,000 (forced sale/auction).

* Further assume that the values specified above will control for purposes of the following questions.

Questions

1. You represent Associated Lenders. Assume you filed a motion for relief from stay on behalf of Associated Lenders on May 1, 1991.

   a. At hearing, what will you argue is the amount of Associated Lenders' secured claim? (3 points)

   b. What Bankruptcy Code subsection and/or case govern your analysis and why? (2 points)

   c. Will the Bankruptcy Judge grant lift of stay? Why or why not? (2 points)

   d. Is Associated Lenders entitled to post-petition interest on its secured claim? Why or why not? (2 points)

   e. What adequate protection, if any, could the Bankruptcy Judge order for Associated Lenders and why? (5 points)

2. You represent Friendly Bank. You advise United that Friendly Bank will not consent under 11 USC § 363(c)(2)(A).

   a. List the types and amounts of cash collateral in which Friendly has an interest and indicate why. (4 points)

   b. Does Friendly Bank have an interest in post-petition inventory? Why or why not? (4 points)

3. What is the amount of the secured claim, if any, of the Internal Revenue Service and why? (5 points)

4. Assume the case is converted to Chapter 7 on February 1, 1992, and that all machinery and equipment is sold for 75% of the commercially reasonable liquidation value previously indicated. Assume the amounts owed to each secured creditor as of the petition date have remained the same (assume no adequate protection payments were made and no interest has accrued post-petition). What claims and in what amounts does Associated Lenders now have in the Chapter 7 and why? (5 points)

Part C

Chapter 11 Plan of Reorganization Questions

1. Welding Company's Chapter 11 Plan of Reorganization provides the following payments to the class of general unsecured claims (Class V):

5/1/91 (effective date)	$ 40,000
5/1/93 (two years later)	$ 75,000
5/1/94 (three years later)	$100,000

   Welding Company's Disclosure Statement states that in liquidation, after payment of applicable priority claims, a payment of $200,000 will be made to Class V. Assume liquidation would take two years to complete. Assume the appropriate present value discount rate is 12%. Assume the Plan is not unanimously accepted by impaired classes.

   (a) Will the Plan satisfy the "best interests of creditors" test? Why or why not? (4 points)

   (b) What Code section governs your answer? (2 points)

   (c) Can a Plan be confirmed under "cram down" if the "best interest of creditors" test is not satisfied? Why or why not? (4 points)

2. You are presented with a Chapter 11 Plan of Reorganization and voting results [**in brackets**] as follows:

   III. Treatment of Claims and Interest

   A. Class 1 -- Allowed Secured Claim of Left Bank. This class is impaired. [**Left Bank votes to accept the Plan**].

   B. Class 2 -- Allowed General Unsecured Claims. The holders of allowed claims in this class shall receive 30% of their allowed claims in cash on confirmation. [**Twelve creditors filed ballots rejecting the Plan; twelve creditors filed ballots accepting the Plan; allowed unsecured claims total $120,000; the aggregate amount of claims accepting the Pla**

was $70,000; the aggregate amount of claims rejecting the Plan was $20,000.]

C. Class 3 -- Shareholder Interests. This class will keep its stock. [**The shareholders vote unanimously to accept the Plan**].

(a) Is the Plan confirmable? Why or why not? (4 points)

(b) How would you modify the Plan so that it could be confirmed? (4 points)

(c) Upon what Code section and/or case would you rely to obtain confirmation of the Plan as so modified? (2 points)

3. You are presented with a Chapter 11 Plan of Reorganization which provides the following treatment for the secured claim of Secure Bank:

III. Treatment of Claims and Interests

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B. Class 2 -- Allowed Secured Claim of Secure Bank. The allowed secured claim of Secure Bank shall be paid in four equal annual installments of $100,000 each commencing one year after the date of confirmation of the Plan. Secure Bank shall retain its first lien on all machinery and equipment according to the terms of the original security agreement.

The balance owed to Secure Bank as of the date of petition was $500,000 including accrued interest at 12% per annum. The machinery and equipment was valued at $250,000 at an earlier hearing on Secure Bank's Motion for Relief from Stay. Assume Secure Bank votes to reject the Plan and makes a § 1111(b)(2) election.

(a) Under what Bankruptcy Code subsection must the Plan proponent proceed to obtain confirmation of the Plan? Why? (3 points)

(b) Does the prior valuation of $250,000 govern at the confirmation hearing? Why or why not? (3 points)

(c) If the Court values the machinery and equipment at $275,000 at confirmation and the appropriate discount rate is 10%, can the Plan be confirmed? Why or why not? What Bankruptcy Code subsection(s) govern your answer? (4 points)

END OF EXAMINATION

RECENT BANKRUPTCY DECISIONS

The following are summaries of recent court decisions that address important issues of bankruptcy law and procedure. These summaries were prepared by Jahel H. Nolan with the assistance of Larry Ver Merris.

In re ZZZZ Best Co., 1991 WL 258044 (U.S.). This case involves the question whether interest payments on a revolving line of credit were made in the ordinary course of business for purposes of the preference section. The Trustee in the case sought to recover several prepetition interest payments which the debtor had made to the defendant pursuant to a revolving credit agreement. The defendant argued that these payments were protected from recovery, as they were made in the ordinary course of business. The Bankruptcy Court and the District Court for the Central District of California agreed with the defendant and held that the payments were in the ordinary course of business. The Circuit Court reversed.

The Supreme Court ruled that payments on long term debt, as well as those on short term debt, may qualify for the ordinary course of business exception to the Trustee's power to avoid preferential transfers. Section 547(c)(2) contains no language distinguishing between long and short term debt and therefore provides no support for the Trustee's contention that its coverage extends only to short term debt. The Court went on to say that the Trustee placed primary emphasis, as did the Court of Appeals, on the interest of equal distribution. But the Court stated that the statutory text, which makes no distinction between short term debt, and long term debt precludes an analysis that divorces the policy of favoring equal distribution from the policy of discouraging creditors from racing to the courthouse to dismember the debtor. Long term creditors, as well as trade creditors,

may seek a head start in that race. Therefore, even if the Court accepted the Court of Appeals' conclusion that the availability of the ordinary business exception to long term creditors does not directly further the policy of equal treatment, the Court stated that it must recognize that it does further the policy of deterring the race to the courthouse and may indirectly further the goal of equal distribution as well.

In his concurring opinion, Justice Scalia specifically stated that he thought that it was regrettable that we have a legal culture in which arguments such as this have to be addressed with respect to a statute utterly devoid of language that could remotely be thought to distinguish between long term and short term debt. He stated that the plain text of the statute should have made this litigation unnecessary and unmaintainable.

Boddy v. U.S. Bankruptcy Court, Case No. 90-6523 (6th Cir. December 5, 1991). This opinion, authored by Judge Suhrheinrich, involves the appeal of an award of Chapter 13 attorney fees.

The counsel for the debtor was awarded $500 in attorney fees. It sought an additional $1,156 as interim compensation and $31.93 for reimbursement of expenses under 11 USC §§ 330 and 331. The Bankruptcy Court awarded the firm $300 in interim expenses and $31.93 for reimbursement of expenses. The District Court affirmed the award and the law firm appealed, claiming that the normal and customary standard used by the Bankruptcy Court to determine the interim fee award was arbitrary and contrary to 11 USC §§ 329 and 330. Compensation awards are authorized by 11 USC § 330, which provides for reasonable compensation for actual necessary services rendered based on the nature, the extent and the value of such services and the cost of comparable services.

The Court stated that in determining a reasonable attorney fee, federal fee-shifting statutes are often used. Under the typical federal fee-shifting statute, the "lodestar" amount is calculated by "multiplying the attorney's reasonable hourly rate by the number of reasonable hours expended." The "lodestar" method of fee calculation is the method the U.S. Supreme Court has stated that federal courts should use when awarding attorney fees.

The Court found that the Bankruptcy Court awarded what it thought was reasonable and customary. However, it should have determined a reasonable hourly rate for the particular attorney handling the case and then multiplied that rate by the reasonable hours worked on that case. Failure to do so was an abuse of discretion. Accordingly, the case was reversed and remanded.

Chevy Chase FSB v. DeGraves, Case No. 1:91-CV-729 (W.D. Mich. November 12, 1991). This opinion, authored by District Judge Benjamin Gibson, involves the question whether a bankruptcy judge has the authority to reject a settlement. DeGraves obtained a credit card from Chevy Chase Bank without a full credit check. He immediately obtained $4,500 in cash advances to pay other debts. DeGraves made one $100 payment on the credit card and then filed for bankruptcy. During the bankruptcy, the bank argued that the credit card had been obtained fraudulently and that the debt was non-dischargeable.

After the debtor's attorney withdrew, the debtor and the appellant entered into a settlement of the debt. The debtor agreed to pay a portion of the debt in future installments. However, when the parties attempted to put their settlement on the record, the bankruptcy judge rejected the settlement because it was unfair to the debtor.

The bank argued that the bankruptcy judge had no authority to reject the settlement. The District Court stated that the parties may settle their claims privately out of court, but judicial settlements are always subject to court approval. Therefore, the bankruptcy judge permissibly refused to approve the settlement agreement submitted to him.

Chevy Chase FSB v. Mauk, Case No. 1:91-CV-43 (W.D. Mich. September 4, 1991). This case involves the appeal of a Bankruptcy Court order denying a motion to have a credit card debt held non-dischargeable pursuant to 11 USC § 523. In June of 1990, Chevy Chase filed an adversary proceeding seeking to have a credit card debt incurred by Mauk declared non-dischargeable, claiming that he had falsely misrepresented his income on his credit card application. After the trial held in November, 1990, the Bankruptcy Court concluded that the debt was dischargeable. Chevy Chase appealed.

On August 12, 1987, Mauk completed and signed an application for a Gold MasterCard issued by Chevy Chase. He received the application in the mail. Before mailing the applications to prospective credit card customers, Chevy Chase pre-screened those persons by reviewing their credit files. Mauk was issued a MasterCard with a credit limit of $10,000. During a 20 day period beginning on October 8, 1987, Mauk charged his entire credit limit of $10,000 to his account by taking out three

separate cash advances. In September of 1989, Chevy Chase finally revoked Mauk's credit privileges. By then, he had incurred various additional charges for goods and services, finance charges, late payment charges and annual fees. He also made a number of payments on the account ranging in amounts from $30.00 to $1,358. By the time he filed bankruptcy, Mauk remained indebted to Chevy Chase in the amount of $8,337.

Mauk was self-employed as an owner and operator of two Kentucky Fried Chicken franchises. On his credit application he listed his employer as Mauk Enterprises. He also listed an annual salary of $75,000, although his income tax returns showed an income of substantially less. The District Court found that the Bankruptcy Court's comments implicitly indicated that Mauk's statement on his application was false. There was little doubt that Mauk's statement regarding his income was untrue and therefore the Court could not conclude that the Bankruptcy Court's implicit determination of falsity was clearly erroneous. The Bankruptcy Court explicitly found that Mauk had no intent to deceive the Bank in stating that his income was $75,000, although the Court did find that Mauk's statement concerning his income was at least reckless, indicating an intent to deceive.

The District Court agreed with the Bankruptcy Court's finding that the Bank did not rely on Mauk's representation regarding his income and concluded that even if there was reliance, such reliance was not reasonable. In its testimony, the Bank stated that it used three tests in determining whether to issue a credit card to a particular applicant. First, the applicant had to meet the Bank's minimum income requirement of $30,000 per year in order to qualify for a Gold Card. Second, the applicant had to pass a net disposable income test determined with reference to monthly income and expenses, and last, the applicant had to have a good credit history. The Court stated that even assuming that the Bank did in fact verify Mauk's credit history, it concluded that the Bank's reliance on Mauk's representation was unreasonable as a matter of law. The Bank made no effort to verify the income information which was supposedly so important to its decision.

Parker v. North American Interstate, Inc., Case No. 91-70617 (E.D. Mich. August 20, 1991). This opinion, authored by Judge Paul V. Gadola, involves the reopening of a Chapter 7 case. In his bankruptcy proceeding, the debtor failed to list North American Interstate, Inc. as a creditor because he was under the impression that the defendant's repossession of certain property operated as a release and satisfaction. After the bankruptcy case was closed, North American sued the debtor in state court for the indebtedness. Debtor defended the suit based on his bankruptcy discharge. North American was granted summary disposition in state court. The debtor moved to reopen the bankruptcy proceedings to add North American as an unsecured judgment creditor. The Bankruptcy Court denied his motion, finding that the creditor was prejudiced by the debtor's defense of the suit.

The District Court stated that the expense of litigation was not sufficient to deny reopening of a no-asset Chapter 7 case. It stated that 11 USC § 523(a)(3) is no bar to discharge unless the creditor can show that it could have prevailed on an objection to discharge based on 11 USC § 523(a)(2), (4) or (6). Accordingly, the Court held that North American was not prejudiced by the debtor's omission of its debt unless North American could have established that it actually had grounds under § 523(a)(2)(4) or (6) for an exception to discharge.

In re O.H. Holding Co., 1991 W.L. 214104 (Bkrtcy. E.D. Mich). This opinion, authored by Judge Arthur J. Spector, involves the termination of a lease under § 365(a). Hickory Inn leased restaurant property to the debtor on July 21, 1988. On February 19, 1991, the landlord sent a letter to the debtor stating that it was exercising its rights to reenter and repossess the premises. Debtor filed bankruptcy on April 9, 1991. Hickory Inn argued that this was a termination of the lease and therefore the debtor was unable to assume the lease under § 365(a).

The Court ruled that the lease was not validly terminated pre-petition in accordance with Michigan law, as Michigan law provided a right to redeem a lease until the expiration of a ten-day post-judgment period. Because the landlord did not even commence judicial proceedings before the debtor's bankruptcy petition was filed, it was clear that the lease was not effectively terminated pre-petition for purposes of § 365.

In re Smith, 131 B.R. 959 (Bkrtcy. E.D. Mich. September 30, 1991). This opinion, authored by Judge Arthur J. Spector, involves an exception to discharge under § 523(a)(5). The action was commenced by the debtor's ex-wife for a determination that the debt owed to her, memorialized in their divorce judgment, was non-dischargeable. The Smiths were married in 1980, had a child in 1985 and by 1987 had filed for divorce. On April 15, 1988, a final consent judgment of divorce without a trial was entered. The judgment contained the

usual provisions for child custody and child support payments to be made by the debtor. The judgment required that the debtor provide for the child's education and name her as a beneficiary of a $50,000 insurance policy on his life. The judgment also provided that neither party would be entitled to alimony and in lieu of dower the debtor was to pay his ex-wife $25,000. The first $5,000 would be paid by July 1, 1992, and the remaining $20,000 would be paid by July of 1994.

Looking to the formula established in Long v. Calhoun, 715 F.2d 1103 (6th Cir. 1983), the Court first concentrated on the element of intent. The Court stated that since Calhoun spoke in terms of the intention of the parties in the plural, it would seem that the intention to provide support must be mutual. The Court concluded that Calhoun's intent requirement is not satisfied unless it is demonstrated that the divorce court or both parties intended to establish an obligation in the nature of support. The Court stated that the timing of the payments of the $25,000, the structure and language of the stipulated divorce judgment and the fact that the judgment was entered into by consent of the parties, served as strong evidence that not only the Court, but the parties themselves, intended to preclude alimony payments.

The Court stated that the plaintiff could not prevail merely by proving that she sought the payment as a means of supporting her child. Under Calhoun, the plaintiff must demonstrate that the defendant likewise intended the $25,000 payment to serve as a form of support. This the defendant denied. He testified that he agreed to pay the plaintiff $25,000 because his lawyer recommended it and because he wanted the divorce ended. He felt he owed the plaintiff something because she helped support him while he was away at medical school. The Court found that the plaintiff failed to satisfy her burden of proof with respect to the issue.

The Court also noted that the assumption underlying the plaintiff's argument was that an obligation which does not represent a property settlement must necessarily be alimony or other support. But the Court stated that an obligation which is not in the nature of a property settlement is not necessarily support. In summary, the Court stated that the evidence established that the plaintiff intended some portion of the $25,000 payment to provide better living conditions for her child. On the other hand, to the extent the defendant had any particular intent with respect to the nature of the $25,000, it was to compensate the plaintiff for supporting the family while he was in medical school. From the defendant's perspective, it appeared that the obligation in effect constituted a recognition of the plaintiff's equitable claim against him. The Court thus concluded that the plaintiff failed to demonstrate that the defendant intended the $25,000 payment to be a form of alimony or other support. Therefore, the debt was dischargeable.

In re Arnold, 132 B.R. 13 (Bkrtcy. E.D. Mich. September 27, 1991). This case, authored by Judge Arthur J. Spector, involves a Chapter 7 Trustee's effort to avoid payment made to a creditor within 90 days before the date of filing of the bankruptcy petition pursuant to a writ of garnishment.

On December 19, 1988, First of America Bank obtained a judgment against the debtor in the amount of $5,404.40. In an effort to collect the judgment, the bank served an affidavit and writ of garnishment upon the Michigan Department of Treasury on February 17, 1989. Pursuant to the writ, the state filed a garnishment disclosure in the state district court on June 14, 1989. On the same date or shortly thereafter, the state turned over to the bank the sum of $1,598.24. Two weeks later, on June 28, 1989, the debtor filed his bankruptcy petition. The trustee contended that for purposes of § 547(b), the transfer of an interest of the debtor in property occurred on June 14, 1989, which was the date the garnishment disclosure was filed and was therefore within the statutory 90-day period. The bank argued that the transfer actually occurred on the date that the writ of garnishment was served, which was more than 90 days before the filing.

The Court stated that in order to determine when the transfer actually occurred, reference must be made to 11 USC § 547(e). This section provides that a transfer is made at the time such transfer is perfected and a transfer of property other than real property is perfected when a creditor on a simple contract cannot acquire a judicial lien that is superior to the interests of the transferee. Thus, the Court found that the transfer took place when the bank's interest was perfected as against subsequent judicial liens obtainable against the debtor by creditors on a simple contract.

The Court could find no authority which explicitly stated the requirements in Michigan for perfection of a post-judgment garnishment. It is clear under Michigan law, however, that a garnishment lien attached upon service of the writ. The Court went on to say that since the entry of a judgment perfects a pre-judgment garnishment lien, the Court believed that a post-judgment lien is perfected when the writ is served.

The Court also noted that the bank's receipt of payment within the preference period actually constituted a second transfer which could be subject to challenge under § 547(b), but because the bank held a perfected security interest in the money paid, the payment was in essence a surrender to the bank of collateral for its undersecured claim. The Trustee could therefore not avoid the payment under § 547(b) because it did not permit the bank to receive more than it would have otherwise been entitled to receive under the Code.

LOCAL BANKRUPTCY STATISTICS

The following is a summary of the number of bankruptcy cases commenced in the United States Bankruptcy Court for the Western District of Michigan (Lower Peninsula) during the period from January 1, 1991 through November 30, 1991. These filings are compared to those made during the same period one year ago and two years ago.

	1/1/91 - 11/30/91	1/1/90 - 11/30/90	1/1/89 - 11/30/89
Chapter 7	4,641	3,665	3,031
Chapter 11	142	142	89
Chapter 12	23	17	16
Chapter 13	1,569	1,562	1,186
	6,375	5,386	4,322

EDITOR'S NOTEBOOK

In another case of note, certiorari has been granted by the United States Supreme Court to review a Third Circuit case which held that, in the absence of a timely objection, a Chapter 7 debtor's exemption claim of the proceeds of a discrimination lawsuit had to be allowed. Taylor v. Freeland & Kronz, (Docket No. 91-571), 1991 W.L. 210508. The Third Circuit in the case below, which is reported at 938 F.2d 420, read § 522(l) literally. That subsection provides that property claimed is exempt unless a party in interest files a timely objection. The Third Circuit's decision is in conflict with the decision of the Sixth Circuit in In re Dembs, 757 F.2d 777, and of the Eighth Circuit's decision in In re Peterson, 920 F.2d 1389. Both courts hold that a bankruptcy court may examine a claimed exemption to determine if a "good faith statutory basis" exists to claim the exemption, even if no timely objection was filed.

Please note that there are no Steering Committee Minutes in this month's newsletter as the monthly meeting was not held due to the holidays.

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