Special Issues in Solvent Debtor Cases

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Solvent Debtors

A.B.I. Rocky Mountain
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Hon. Howard R. Tallman, United States Bankruptcy Court, District of Colorado;
J. Thomas Beckett, Parsons Behle & Latimer;
Michael R. Johnson, Ray Quinney & Nebeker; and
Christian C. Onsager, Onsager, Guyerson, Fletcher & Johnson

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1. Filing Issues:

a. Solvency.

i. 11 U.S.C. § 101(32): "Insolvency" means:

1. For any entity other than a partnership or municipality: financial condition such that debts exceed assets (balance sheet test) exclusive of (i) property transferred with intent to hinder creditors, and (ii) property that is exempt under § 522.

2. For partnership: the balance sheet of the partnership plus the positive balance sheet of each partner.

3. For municipality: generally not paying its debts as they become due unless such debts are the subject of a bona fide dispute (income statement test).

b. Is Bankruptcy available to solvent debtors?

i. 11 U.S.C. § 303(h): no order for relief in involuntary cases, unless debtor unable to pay debts as they mature.

ii. 11 U.S.C. § 109: no order for relief in municipal cases, unless debtor unable to pay.

iii. 11 U.S.C. § 301 / 11 U.S.C. § 109: no such restriction for voluntary petitions. Nothing says the debtor must be insolvent or unable to pay its debts.

iv. Good faith as a filing requirement—Plan must be proposed in good faith, 11 U.S.C. § 1129(a)(3) but where is the statutory requirement that the case itself be filed in good faith?

1. *In re Marsch*, 36 F.3d 825 (9th Cir. 1994) (there is a general requirement, in order to safeguard the integrity and purpose of Chapter 11, that the Chapter 11 petition must be filed in good faith and, if it is not, the case can be converted or dismissed)

2. *In re Integrated Telecom Express, Inc.*, 384 F.3d 108 (3d Cir. 2004) (solvent debtor with no intent of reorganizing did not file its petition in good faith where the debtor filed solely to limit the landlord's rejection damages claim).

c. Motions to Dismiss:

i. 11 U.S.C. § 1112 (conversion, dismissal, trustee or examiner)

1. *Hall v. Vance*, 887 F.2d 1041, 1044 (10th Cir. 1989): "The bankruptcy code enumerates ten grounds upon which a bankruptcy court may dismiss a Chapter 11 case or convert it into a case under Chapter 7. 11 U.S.C. § 1112 (b)(1)-(10). This list is not exhaustive. H.R.Rep. No. 595, 95th Cong., 1st Sess. 405-06, *reprinted in* 1978 U.S.Code Cong. & Admin.News 5963, 6361-62; *In re Larmar Estates, Inc.,* 6 B.R. 933, 936 (Bankr.E.D.N.Y.1980). Dismissal or conversion must be at the request of a party, after notice and a hearing, and for cause. 11 U.S.C. § 1112(b); 5 *Collier on Bankruptcy* ¶ 1112.03, at 1112-14 (15th ed. 1979). The bankruptcy court has broad discretion under §1112(b). S.Rep. No. 989, 95th Cong., 2d Sess. 117, *reprinted in* 1978 U.S.Code Cong. & Admin.News 5787, 5903; *In re Koerner,* 800 F.2d 1358, 1367 (5th Cir.1986).

2. *In re Frieouf (Frieouf v. U.S.A.*), 938 F.2d 1099 (10th Cir. 1991) (regarding dismissal of bankruptcy with prejudice or with bar order).

3. *In re Preferred Door Company, Inc.* (S.B.A. and I.R.S. v. Preferred Door Company, Inc.) (10th Cir. 1993) (dismissal for failure timely to confirm chapter 11 plan).

4. *In re Gier (Gier v. Farmers State Bank of Lucas, Kansas)*, 986 F.2d 1326 (dismissal for failure timely to confirm chapter 13 plan).

ii. For cause:

1. Bad Faith (avoiding the inevitable):

a. *In re Nursery Land Development, Inc. (Udall v. F.D.I.C.*), 91 F.3d 1414 (10th Cir. 1996): Debtor (1) has only one asset; (2) has only one creditor; (3) acquired property which was posted for foreclosure and the prior owners had been unsuccessful in defending against the foreclosure; (4) was revitalized on the eve of foreclosure to acquire the insolvent property; (5) has no ongoing business or employees; and (6) lacks a reasonable possibility of reorganization, and (7) the Chapter 11 filing stopped the foreclosure.

b. *Laguna Assocs. Ltd. Partnership v. Aetna Casualty & Sur. Co. (In re Laguna Assocs. Ltd. Partnership),* 30 F.3d 734, 738 (6th Cir. 1994) (listing indicia of bad faith Chapter 11 filing).

c. *Little Creek Dev. Co. v. Commonwealth Mortgage Corp. (In re Little Creek Dev. Co.),* 779 F.2d 1068, 1072-73 (5th Cir. 1986) (same).

d. *In re Courtesy Inns, Ltd., Inc. (Jones v. Bank of Santa Fe)*, 40 F.3d 1084 (10th Cir. 1994) (extensive analysis re sanctions available in case of bad faith filing).

e. *In re C-TC 9th Ave. P'ship v. Norton Co. (In re C-TC 9th Ave. P'ship)*, 113 F.3d 1304, 1309 (2d Cir. 1997). Debtor was (i) was ineligible to be a debtor under section 109; (ii) had filed its petition only as a tactic to forestall litigation in a two-party dispute; and (iii) was incapable of confirming a reorganization plan.

f. *In re Wally Findlay Galleries (New York), Inc.,* 36 B.R. 849, 850 (Bankr. S.D.N.Y. 1984) (dismissing case where petitioner filed for the purpose of avoiding judgments rather than reorganizing debts).

g. *Pleasant Pointe Apartments, Ltd. v. Kentucky Hous. Corp.*, 139 B.R. 828 (W.D.Ky. 1992): (i) The debtor has only one asset; (ii) The debtor has few unsecured creditors whose claims are small in relation to those of

the secured creditors; (iii) The debtor's one asset is subject to a foreclosure action as a result of arrearages or default on the debt; (iv) The debtor's financial condition is, in essence [the result of] a two party dispute between the debtor and secured creditors which can be resolved in the pending state foreclosure action; (v) The timing of the debtor's filing evidences an intent to delay or frustrate the legitimate efforts of the debtor's secured creditors to enforce their rights; (vi) The debtor has little or no cash flow; (vii) The debtor cannot meet current expenses including the payment of personal property and real estate taxes; and (viii) The debtor has no employees.

2. Bad Faith: (Solvent Debtors avoiding having to post a supercedeas bond on appeal).

    a. It is the Debtors' burden to show that they had no alternative to using chapter 11 to obtain a stay pending appeal. *In re Byrd*, 172 B.R. 970, 973 (Bankr. W.D. Wash. 1994) ("unless the debtor can demonstrate that he has no alternative to stay [the judgment] other than by chapter 11, his petition must be dismissed.")

    b. *In re Chu*, 253 B.R. 92, 97 ("The decisions that have approved the use of bankruptcy to avoid posting a bond involved cases where the evidence unequivocally demonstrated the debtor's good faith.").

    c. *In re Sparklet Devices*, 154 B.R. 544, 548-49 (Bankr. E.D. Mo. 1993): [I]n those cases in which a court has permitted a Chapter 11 filing as a functional equivalent of a supersedeas bond, one of two standards was met: (1) a multinational company faced mass tort litigation; or (2) a large judgment would force the debtor to close its business and liquidate. In both lines of cases, however, the crucial element to the finding of good faith has been the fact that the Debtor was an on-going concern with employees and the means to reorganize.

    d. *In re Marsch*, 36 F. 3d 825, 829 (9th Cir. 1994): Several bankruptcy courts have held that a debtor may

use a Chapter 11 petition to avoid posting an appeal bond if satisfaction of the judgment would severely disrupt the debtor's business. A petition filed for this purpose doesn't comport with the objectives of the bankruptcy laws, however, if the debtor can satisfy the judgment with nonbusiness assets. *** [Here,] the bankruptcy court found that the debtor had the financial means to pay the judgment. *** These factual findings are clearly supported by the record; the bankruptcy court thus correctly held that the debtor's petition was filed in bad faith. Dismissal of the petition for cause pursuant to section 1112(b) was proper.

e. *In re Sletteland*, 260 B.R. 657, 664-66 (Bankr. S.D.N.Y. 2001): "In applying the above factors to the case at bar, the filing here bears none of the "core" indicia of "bad faith." The Debtor did not transfer assets or take any other action to hinder or delay creditors prior to the filing of the case. With respect to the first and, to many courts, key factor listed above, the [movant] does not argue that the Debtor has the means to pay the judgment or obtain an appeal bond. In their words, "the Debtor is insolvent" (emphasis in original).

f. *In re Fox*, 232 B.R. 229, 234 (Bankr. D. Kan. 1999) ("The focus of this inquiry should be on whether the debtor had the ability to post the bond without losing the ability to stay in business.").

g. *In re Wally Findlay Galleries (New York)*, 36 B.R. 849, 851 (Bankr. S.D.N.Y. 1984) (court dismissed petition of debtor who could not afford to post a bond, concluding, "[t]his court should not, and will not, act as a substitute for a supersedeas bond.")

2. Plan Issues

a. Impairment.

i. Section 1124: A class of claims *or interests* is impaired under a plan unless, with respect to each claim or interests of such class, the plan

leaves unaltered the legal, equitable, and contractual rights to which such claim or interest is entitled.

ii. Section 1129(a)(10): *If* a class of claims is impaired under the plan, at least one class of claims that is impaired under the plan must accept the plan, determined without including any acceptance by an insider.

iii. Unsecured creditors—post petition interest/what rate/timing as it relates to confirmation?

1. *In re PPI Enterprises*, 228 B.R. 339, 352 (Bankr. D. Del. 1998) ("Congress . . . intended that to be unimpaired, the claim must receive postpetition interest").

2. *In re Rocha*, 179 B.R. 305, 307 n.1 (Bankr. M.D. Fla. 1995) ("[A] solvent debtor must now pay post-petition and pre-confirmation interest on a claim to have a class considered 'unimpaired.' Section 1124(3) has been deleted in its entirety, which had previously allowed a class of creditors to be considered 'unimpaired' without paying interest on the claim.").

3. *In re Greg Adams Enterprises, Inc.*, 2011 B.R. 1605 (E.D. N.C. case # 10-09784) (May 2, 2011) (refusing to dismiss solvent Chapter 11 case on bad faith grounds even though debtor would reorganize using a "status quo" plan under which "no class of creditors would need to accept the plan under § 1129(a)(8)(B) because each such class would be exempted from the acceptance process pursuant to Section 1129(a)(8)(B) of the Bankruptcy Code").

iv. Plan Impairment vs. Statutory Impairment—What about statutory impairment, like rejection damage claims under Section 502(b)(6)? *See In re PPI Enterprises*, 228 B.R. at 353-54 (even solvent debtor can use statutory impairment to limit claims); *In re Smith*, 123 B.R. 863, 867 (Bankr. C.D. Cal. 1991) ("A plan may limit payment of claims 'to the extent allowed' without impairing them; for until claims are allowed, or deemed allowed, the holders thereof are not entitled to distribution from the bankruptcy estate.").

b. Post-petition interest and fees.

i. Post-petition Interest.

1. The general rule is no post-petition interest. 11 U.S.C. § 502(b)(2)

2. There are three exceptions:

    a. Debtor is solvent.
    b. Creditor is over-secured.
    c. Creditor is unimpaired

3. Solvent Debtor Rule: Creditors receive the "legal rate" of interest from solvent debtors.

    a. 11 U.S.C. § 1129(a)(7)(A)(ii): With respect to each impaired class of claims or interests, each holder of a claim or interest of such class has accepted the plan; or will receive or retain under the plan on account of such claim or interest property of a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive or retain in if the debtor were liquidated under chapter 7 of this title on such date.

    b. 11 U.S.C. § 726(a)(5): Except as provided in section 510 of this title, property of the state shall be distributed … (5) *fifth*, in payment of interest at ***the legal rate*** from the date of the filing of the petition ….

4. What is the "legal rate"

    a. *In re Cardelucci (Onink v. Cardelucci)* 285 F.3d 1231 (9th Cir. 2002)

        i. Where a debtor in bankruptcy is solvent, an unsecured creditor is entitled to "payment of interest at the legal rate from the date of the filing of the petition" prior to any distribution of remaining assets to the debtor. 11 U.S.C. § 726(a)(5). The question presented by this appeal is whether "interest at the legal rate" means a rate fixed by federal statute or a rate determined either by the parties' contract or state law. The Bankruptcy Code does not define the term "interest at the legal rate" and there is a paucity of legislative history regarding this statutory provision.

        ii. Bankruptcy courts have split over the correct interpretation of this phrase, finding that it either

means one single rate as determined by 28 U.S.C. § 1961(a)(the "federal judgment rate approach") or is based on a contract rate or applicable state law (the "state law approach"). Compare *In re Dow Corning Corp.,* 237 B.R. 380, 394 (Bankr.E.D.Mich. 1999) (applying the federal judgment rate), with *In re Carter* 220 B.R. 411, 416-17 (Bankr.D.N.M.1998) (using the state law approach to determine the appropriate interest rate).

iii. In *In re Beguelin*, 220 B.R. 94, 99 (9th Cir. BAP 1998), the Bankruptcy Appellate Panel of the Ninth Circuit squarely addressed the issue presented in this appeal. The BAP held that the federal judgment rate applied to post-petition interest. *Beguelin*, 220 B.R. at 100. Contrasting the state law and federal judgment rate approaches, the BAP concluded that the interests of "fairness, equality, and predictability in the distribution of interest on creditors' claims" as well as the interest in applying federal law to federal bankruptcy cases, required application of the federal judgment rate approach.

b. *Cardelucci* followed *Beguelin*.

c. *In re Dow Corning Corp*., 237 B.R. 380 (Bankr. E.D. Mich. 1999) (federal judgment rate).

d. *In re Schoenberg*, 156 B.R. 963 (Bankr. W.D. Tex. 1993) (non-default contract rate).

e. *In re Fast*, 318 B.R. 183 (Bankr. D. Colo. 2004) After acknowledging *Cardelucci*, Judge Brooks courageously wrote, “Here, the equities do not support application of an interest rate other than that as contracted by the parties. First, this is a small case, with a limited number of creditors, and the effort and difficulty in determining the contract rate and apply it is minimal. Second, although the amount payable is subject to ongoing variation, such as the accumulation of interest at a per diem rate and, possibly, additional attorney's fees (*infra* section IV(D)), there is no uncertainty sufficient

to justify denying the Bank the benefit of its bargain under these specific circumstances. Third, *all* creditors are being paid in full and to allow interest at a rate lower than the rate contracted into by the parties, would reward an unscrupulous and indolent debtor."

5. Contract or default rate of interest? .

   a. *In re Entz-White Lumber and Supply (Great Western Bank & Trust v. Entz-White Lumber and Supply, Inc*.), 850 F.2d 1338 (9th Cir. 1988) (ability to cure, in connection with impairment, means non-default interest paid to over-secured creditor in plan.)

   b. *GECC v. Future Media Productions, Inc*., 536 F.3d 969 (9th Cir. 2008) (oversecured creditor gets default interest under a 363 sale).

ii. Post-petition attorneys fees.

1. *In re Fobian,* 951 F.2d 1149 (C.A.9 1991), which held that "where the litigated issues involve not basic contract enforcement questions, but issues peculiar to federal bankruptcy law, attorney's fees will not be awarded absent bad faith or harassment by the losing party,"

2. *Travelers Casualty & Surety Co. of America v. Pacific Gas & Electric*, 127 S.CT 1199 (2007) (overruling *Fobian* because state law provides substantive rights in bankruptcy).

3. *Ogle v. Fidelity & Deposit Company of Maryland*, 586 F.3d 143 (2nd Cir. 2009) ("In Travelers, the Supreme Court rejected a Ninth Circuit rule disallowing such claims if the fees were incurred litigating issues of bankruptcy law, but reserved decision on the precise question presented on this appeal: whether such claims are allowable categorically. We hold that an unsecured claim for post-petition fees, authorized by a valid pre-petition contract, is allowable under section 502(b) and is deemed to have arisen pre-petition.

4. *In re Busch (Busch v. Hancock)*, 369 B.R. 614 (10th Cir. BAP 2007) (following *Travelers*).

iii. 11 U.S.C. § 506(b): (over-secured claim) To the extent that an allowed secured claim is secured by property the value of which, after recovery under subsection (c) of this section, is greater than the amount of such

claim, there shall be allowed to the holder of such claim, interest on such claim, and any ***reasonable*** fees, costs, or charges provided for under the ***agreement or State statute*** under which such claim arose.