Problems, Problems, Problems (Business)

Hon. Arthur I. Harris, Moderator
U.S. Bankruptcy Court (N.D. Ohio); Cleveland

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Hon. Arthur I. Harris, United States Bankruptcy Judge
United States Bankruptcy Court for the Northern District of Ohio, Cleveland

J&J Homes: § 1111(b) and the New Value Exception

Over the past seven years, Jane and John Smith purchased about 20 modest single family homes hoping to rent them out or resell them for a profit. The Smiths financed their purchases through several banks, who took mortgages as security for the loans. About a year later, the Smiths quitclaimed the properties to J&J Homes, LLC (J&J Homes), a limited liability company that they had created after a lawyer suggested that the Smiths limit their personal liability by transferring the mortgaged properties. The transferred properties remained subject to the banks' mortgages, but the banks did not consent to the transfers or relieve the Smiths of their own personal liability for the money loaned. In fact, the notes and mortgages did not permit the transfer of the properties without the banks' permission.

When the Smiths and J&J Homes ran into tough times, J&J Homes filed for bankruptcy under chapter 11, thereby staying the banks' efforts to pursue foreclosure proceedings. The banks moved for relief from stay. Meanwhile, J&J Homes filed a plan and disclosure statement proposing to cramdown each of the nonrecourse obligations of J&J Homes into new 30-year fixed loans at 4 1/2 percent interest, based on current valuations well-below the amounts owed for each home. The banks opposed confirmation, arguing, among other reasons, that J&J Homes could not use chapter 11 to modify the treatment of these loans, which had been transferred to J&J Homes without their permission and remained fully recourse loans as to the Smiths.

1. What arguments at confirmation would you make if you represent the banks?
2. What arguments would you make if you represent the debtor, J&J Homes?
3. What about the banks' ability to elect treatment under § 1111(b)(2)?
4. What if the plan included an injunction against the banks suing the Smiths personally, provided that J&J Homes remains current in its payments to the banks under the new terms provided in the Chapter 11 plan?
5. If J&J Homes needs to rely on the cramdown provisions of § 1129(b) for confirmation, which, if any, of the following would be acceptable as new value?
    a. Forgiveness of a $20,000 unsecured loan that the Smiths made to J&J Homes.

b. A cash contribution of $20,000 from Mr. Smith, who borrows the money from his 401(k) account.

c. A promise to devote 2,000 hours of work without pay or at a reduced pay rate.

d. An offer to contribute $1,000 with any creditors having the right to request an auction and outbid the Smiths for ownership of the reorganized debtor.

6. Should the judge refuse to confirm a plan that does not meet the cramdown requirements of § 1129(b) even if no creditor or party in interest objects?

References:

11 U.S.C. § 1111 – Claims and interests

(b)

(1)

(A) A claim secured by a lien on property of the estate shall be allowed or disallowed under section 502 of this title the same as if the holder of such claim had recourse against the debtor on account of such claim, whether or not such holder has such recourse, unless—

(i) the class of which such claim is a part elects, by at least two-thirds in amount and more than half in number of allowed claims of such class, application of paragraph (2) of this subsection; or

(ii) such holder does not have such recourse and such property is sold under section 363 of this title or is to be sold under the plan.

(B) A class of claims may not elect application of paragraph (2) of this subsection if—

(i) the interest on account of such claims of the holders of such claims in such property is of inconsequential value; or

(ii) the holder of a claim of such class has recourse against the debtor on account of such claim and such property is sold under section 363 of this title or is to be sold under the plan.

(2) If such an election is made, then notwithstanding section 506 (a) of this title, such claim is a secured claim to the extent that such claim is allowed.

Bank of Am. Nat. Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434 (1999).

Norwest Bank Worthington v. Ahlers, 485 U.S. 197 (1988).

United Student Aid Funds, Inc. v. Espinosa, 559 U.S. 260 (2010).

In re DJM Holdings, Ltd., Case No.10-20758 (Bankr. N.D. Ohio).

HIGH STAKES LITIGATION

Motor City Casino Corporation is a large Delaware corporation that operates dozens of casinos across the Midwest and East Coast. Approximately 24,000 of Motor City's 55,000 employees work at its Detroit headquarters and at casinos in Utica, Kalamazoo, and Bay City. It also operates several casinos in the mid-Atlantic region, including two of its largest casino resorts in Atlantic City, New Jersey, and a small racino in Dover, Delaware. Motor City substantially expanded its operations in 2006 as part of a massive leveraged buyout, but struggled to service its considerable debt in the wake of the 2008 recession. As a result, Motor City engaged some of its first-priority creditors in discussions to assemble a "pre-packaged" Chapter 11 reorganization to be filed in the Eastern District of Michigan at Detroit in late 2015.

After learning of Motor City's plans, four of Motor City's largest second lien noteholders quickly assembled an involuntary Chapter 11 petition. On August 1, 2015, the noteholders filed their involuntary Chapter 11 petition in the District of Delaware. Nine days later, Motor City filed a voluntary Chapter 11 petition in Detroit.

1. Which bankruptcy court should decide where Motor City's bankruptcy should proceed?

2. You represent Motor City. What arguments can you make in favor of having the Chapter 11 case heard in Detroit?

3. You represent one of the second lien noteholders responsible for the Delaware filing. What arguments can you make in favor of having the Chapter 11 case heard in Wilmington?

References:

28 U.S.C. §§ 1408, 1412.
Fed. R. Bankr. P. 1014.
In re Caesars Entertainment Operating Company, Inc., 2015 WL 495259, Case No. 15-10047-KG (Bankr. D. Del. Feb. 2, 2015).
In re Patriot Coal Corp., 482 B.R. 718 (Bankr. S.D.N.Y. 2012).
Commw. of Puerto Rico v. Commw. Oil Refining Co. (*In re Commw. Oil Refining Co.*), 596 F.2d 1239, 1247 (5th Cir. 1979) ("CORCO").
In re Enron Corp., 274 B.R. 327, 342 (Bankr. S.D.N.Y. 2002).

U.P. MINING

Delaware Holdings, Inc., is a parent company, incorporated in Delaware, that owns various mining subsidiaries. One of its subsidiaries, U.P. Mining, incorporated in Michigan, owns and operates open pit mines in both Michigan and Wisconsin. After an environmental mining disaster at one of the mines in Wisconsin, U.P. Mining files for bankruptcy under chapter 11 in the Western District of Michigan. Virtually all of the assets of debtor U.P. Mining are encumbered by blanket liens held by First Place Bank.

The federal and Wisconsin environmental agencies want to pursue injunctive relief and penalties against U.P. Mining for clean up costs incurred both prepetition and postpetition. The federal and Wisconsin environmental authorities and the unsecured creditors' committee would also like to go after the deep pocket of Delaware Holdings, the debtor's non-filing parent.

1. Can the federal and Wisconsin environmental authorities pursue actions for injunctive relief and civil penalties against the debtor U.P. Mining without first obtaining relief from stay? How about criminal environmental claims? Would any of the penalties be entitled to priority as an administrative expense?

2. What if the debtor U.P. Mining is worried that civil actions against its CEO would interfere with its successful reorganization. Could it successfully ask the bankruptcy court to extend the automatic stay to cover civil actions against its CEO?

3. What theories might the federal and Wisconsin environmental authorities use to go after the deep pocket of Delaware Holdings, the non-filing parent? Corporate veil piercing? Alter ego? Substantive consolidation? An involuntary bankruptcy filing? Would it matter how hands-on a role Delaware Holdings took in U.P. Mining's operations? What if U.P. Mining's CEO was also an officer of Delaware Holdings?

4. What if the parent, Delaware Holdings, had also filed for bankruptcy under chapter 11 in the Western District of Michigan? Would any of the theories be more likely to succeed?

5. In attempting to pierce the corporate veil of debtor U.P. Mining, should the bankruptcy court apply state or federal law? If state law, which state?

6. What if U.P. Mining has an affiliate with deep pockets, Wolverine Trucking, another subsidiary of Delaware Holdings? Can federal and Wisconsin environmental authorities recover from Wolverine?

References:

11 U.S.C. § 362(b)(1), (b)(4).

U.S. v. Bestfoods, 524 U.S. 51, 118 S.Ct. 1876 (1998) (involving veil piercing of parent corporation in connection with subsidiary's environmental violations, as well as direct operator liability under certain environmental laws).

Chao v. Hospital Staffing Servs., Inc., 270 F.3d 374 (6th Cir. 2001) (discussing police or regulatory power exception to automatic stay).

DaimerChrysler Corp. Healthcare Benefits Plan v. Durden, 448 F.3d 918 (6th Cir. 2006) (involving choice of law issues).

In re Appalachian Fuels, 493 B.R. 1 (B.A.P. 6th Cir. 2013) (discussing choice of law in determining derivative liability under CERCLA, as well as parent-subsidiary and subsidiary-affiliate veil piercing theories).

In re Miller, 459 B.R. 657, 671 (B.A.P. 6th Cir. 2011), (noting a split as to whether state or federal law supplies the choice of law rules in bankruptcy cases), *aff'd*, 513 Fed.Appx. 566 (6th Cir. 2013).

Sutherland v. DCC Litigation Facility, Inc. (*In re Dow Corning Corp.*), 778 F.3d 545 (6th Cir. 2015) (choice of law issues in tort action filed in North Carolina and transferred to the Eastern District of Michigan as "related to" a bankruptcy case).

Wise v. Zwicker & Assocs, 2015 WL 1061965, __ F.3d __ (6th Cir., Mar. 12, 2015) (examining choice of law issues in contract disputes).

DETROIT BRIDGE & TUNNEL OPERATIONS & RENOVATIONS, INC.

Detroit Bridge & Tunnel Operations & Renovations, Inc. (DeBTOR) found itself strapped for cash and contemplating bankruptcy. Before filing for bankruptcy under chapter 11, it realized that one means of saving money would be to refinance its senior secured debt, which consisted of a $100,000,000 10-year note paying interest at 10% per year, but did not mature until 2020. DeBTOR's restructuring professionals were able to line up DIP financing that would pay off the entire senior secured debt with a new note at only 5% interest, realizing a substantial savings. The 10-year note included a substantial premium for early voluntary payoff and also included clauses: (1) automatically accelerating the note upon filing bankruptcy and (2) giving the holder the right to rescind the acceleration. Shortly after the bankruptcy was filed, the holder of the note notified DeBTOR that it had elected to rescind the automatic acceleration of the note. The bankruptcy court approved the DIP financing and payoff of the senior secured debt, but left unresolved whether DeBTOR was required to pay the substantial premium for early voluntary payoff.

1. You represent the holder of the note. What arguments do you make in favor of the substantial premium applying to this situation? Does it matter whether DeBTOR was solvent or would not have filed for bankruptcy except for the opportunity to refinance the senior secured debt? Do you need relief from stay to effectuate the notice rescinding the automatic acceleration?

2. You represent DeBTOR. What arguments do you make against the substantial premium applying?

3. Assume that the best refinancing DeBTOR can find for its senior secured debt is 8%. So instead of finding a DIP lender to payoff the old debt, DeBTOR proposes a plan that would simply cram down the interest rate on the note from 10% to 5%, with the note still maturing in 2020. Assume that the holder of the senior secured debt is oversecured for purposes of § 506(b). Can DeBTOR succeed in cramming down the interest rate? Is evidence of the market rate relevant? What about the decision in *Till v. S.C.S. Credit Corp.*, 541 U.S. 465 (2004)? Does it matter that the decision is only a plurality? What about footnote 14?

References:

11 U.S.C. § 1129(b) provides in pertinent part:

> (2) For the purpose of this subsection, the condition that a plan be fair and equitable with respect to a class includes the following requirements:
>
> (A) With respect to a class of secured claims, the plan provides—
>
> (i)
>
> (I) that the holders of such claims retain the liens securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims; and
>
> (II) that each holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property;
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> (ii) for the sale, subject to section 363 (k) of this title, of any property that is subject to the liens securing such claims, free and clear of such liens, with such liens to attach to the proceeds of such sale, and the treatment of such liens on proceeds under clause (i) or (iii) of this subparagraph; or
>
> (iii) for the realization by such holders of the indubitable equivalent of such claims.

11 U.S.C. §§ 502(b)(2), 506(b).

Till v. S.C.S. Credit Corp., 541 U.S. 465 (2004).

American HomePatient, Inc., 420 F.3d 559 (6th Cir. 2005).

In re Energy Future Holdings Corp., No. 14-10979, 2015 WL 1361136 (Bankr. D. Del. Mar. 26, 2015) (Sontchi, J.).

In re MPM Silicones, LLC ("Momentive"), No. 14-22503, 2014 WL 4436335 (Bankr. S.D.N.Y. Sept. 9, 2014) (Drain, J.).

In re Mayslake Vill. Plainfield Campus, Inc., 441 B.R. 309 (Bankr. N.D. Ill. 2010).

In re Settlers' Hous. Serv., Inc., 505 B.R. 483 (Bankr. N.D. Ill. 2014).

A ROYALE MESS

Casino Royale, Inc. (Casino Royale), a struggling gambling casino in Detroit, recently filed for bankruptcy under chapter 11. Casino Royale is owned by various members of the Grump family, who have been feuding with each other ever since Marla Grump, the estranged wife of Casino Royale's CEO Donald Grump, filed for divorce. Big Bank (the bank) is the major secured creditor with a first lien over most of Casino Royale's assets, however, the assets securing the bank's loan are currently worth much less than what Casino Royale owes the bank. Both the bank and the unsecured creditors' committee are concerned that CEO Donald Grump may be making decisions regarding the business and the bankruptcy case based on how they might help him in his divorce case and/or punish his estranged wife and various family shareholders aligned with her. There are also some indications that members of the Grump family have been using Casino Royale as their personal piggy bank, turning an otherwise profitable business into one that is now strapped for cash.

The bank and the unsecured creditors' committee are considering filing a motion to appoint a chapter 11 trustee under section 1104 of the Bankruptcy Code.

1. Should the bank and the unsecured creditors' committee file such a motion together? Separately? With the U.S. Trustee? Who has standing?

2. Do the actions of the debtor-in-possession constitute "cause" for the appointment of a chapter 11 trustee?

3. Assume a party in interest files a motion for the appointment of a chapter 11 trustee in this case. Who has the burden of proof for appointing a chapter 11 trustee? What is the applicable standard of proof for the appointment of a chapter 11 trustee? Preponderance? Clear and convincing?

4. Would the results be any different if, shortly before Casino Royale filed for bankruptcy, a majority of shareholders led by Donald Grump had hired Tina Turnaround, a respected restructuring professional not previously connected with Casino Royale, to be the new CEO?

References:

11 U.S.C. § 1104 – Appointment of Trustee or Examiner

(a) At any time after the commencement of the case but before confirmation of a plan, on request of a party in interest or the United States trustee, and after notice and a hearing, the court shall order the appointment of a trustee—

(1) for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case, or similar cause, but not including the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor; or

(2) if such appointment is in the interests of creditors, any equity security holders, and other interests of the estate, without regard to the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor.

Grogan v. Garner, 498 U.S. 279, 286-87 (1991).

Compare *In re Bayou Grp., LLC*, 564 F.3d 541, 546 (2d Cir. 2009); *In re G-I Holdings, Inc.*, 385 F.3d 313, 317-18 (3d Cir. 2004); *In re LHC, LLC*, 497 B.R. 281 (Bankr. N.D. Ill. 2013) with *In re Keeley & Grabanski Land P'ship*, 455 B.R. 153, 163 (B.A.P. 8th Cir. 2011), *Tradex Corp. v. Morse*, 339 B.R. 823 (D. Mass. 2006).

In re Willowbend Nursery, Inc., Case No. 06-14353 (Bankr. N.D. Ohio Oct. 27, 2007) (oral ruling appointing chapter 11 trustee).