

AN OVERVIEW OF CHAPTER 11 FOR THE NON-BANKRUPTCY LAWYER¹

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¹ Portions of this manuscript previously were presented by Benjamin A. Kahn at the North and South Carolina Bar Associations' Construction Seminar, Wild Dunes, South Carolina, September 14, 2007, entitled, "Someone Filed Bankruptcy? No Problem, I'm a Construction Lawyer," and by Benjamin A. Kahn, George F. Sanderson III, and Margaret R. Westbrook at the North Carolina Bar Association Annual Bankruptcy Institute, November 2008, entitled, "Homebuilder/Construction Bankruptcies and Lien Issues."

I. General Concepts of Bankruptcy Involved in Chapter 11 Cases.

The Supremacy Clause of the United States Constitution gives Congress the exclusive power “[t]o establish ... uniform Laws on the subject of Bankruptcies throughout the United States.” Article I, §8, cl. 4. Since 1978, the United States Bankruptcy Code, 11 U.S.C. § 101 et seq. (the “Bankruptcy Code”) is the codification of that federal, uniform system.

The “prime” policy underlying the Bankruptcy Code is equality of distribution among creditors of equal priority² in order to prevent a “race to the courthouse to dismember the debtor.” Advo-System, Inc. v. Maxway, 37 F.3d 1044, 1047 (4th Cir. 1994) (quoting Harman v. First American Bank of Maryland, 956 F.2d 479, 488 (4th Cir. 1992)). Another “central purpose of the [Bankruptcy] Code is to provide a procedure by which certain insolvent debtors can reorder their affairs, make peace with their creditors, and enjoy ‘a new opportunity in life with a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt.’” Grogan v. Garner, 498 U.S. 279, 286, 111 S.Ct. 654, 659 (1991) (citations omitted).

One must approach issues arising in the bankruptcy context with these central policies in mind. Concepts of fairness in the Bankruptcy Code stem from these policies, rather than from the perspective of fairness to any particular creditor. In fact, the Bankruptcy Code can seem decidedly unfair and counterintuitive from the perspective of any particular creditor where that creditor has provided goods or services to the debtor, for which goods or services the debtor is not going to pay, and from which the debtor may receive a complete release in the form of a bankruptcy discharge.

² It is important to understand the distinction between priority creditors and secured creditors. See discussion, infra, at Section I.E.

A. Who may be a debtor under Chapter 11?

Chapter 11 is available to individuals, partnerships, corporations, limited liability companies, and certain other forms of legal associations. 11 U.S.C. § 109(d), 109(e), 101(9), and 101(41). Cases under Chapter 11 either can be liquidations or reorganizations. In a Chapter 11, the debtor generally remains in possession and control of its assets (a “debtor-in-possession” or “DIP”), and is given the powers of a trustee pursuant to 11 U.S.C. § 1107. However, where there is fraud, dishonesty, incompetence, or gross mismanagement, the court can appoint a Chapter 11 trustee or an examiner. 11 U.S.C. § 1104. A Chapter 11 trustee serves essentially the same functions as a Chapter 7 trustee. However, a Chapter 11 trustee can operate the debtor’s business indefinitely and guide the business through reorganization.

B. Property of the Estate

“The filing of a debtor’s petition in bankruptcy creates an estate comprised of the property listed in 11 U.S.C. § 541(a)” Universal Cooperatives, Inc. v. FCX, Inc., 853 F.2d 1149, 1153 (4th Cir. 1988). Section 541 of the Bankruptcy Code creates and defines property of estate. As stated by the Fourth Circuit:

The act of filing a petition for relief under an applicable chapter of the Bankruptcy Code commences a bankruptcy case and creates an estate consisting of “all legal or equitable interests of the debtor in property as of the commencement of the case.” Upon the filing of a petition, the debtor’s interests in property vest in the bankruptcy estate, and the debtor surrenders the right to dispose of or otherwise control the estate property. In re Osborn, 176 B.R. 217, 219 (Bankr. E.D. Okla. 1994). The bankruptcy trustee, as representative of the bankruptcy estate, has exclusive authority to use, sell or lease property of the estate. 11 U.S.C. §§ 323(a), 363(b)(1).

Richman v. Garza, 117 F.3d 1414, 1997 WL 360644, *1 (4th Cir. 1997) (per curiam) (unpublished).

Pursuant to § 541, property of the estate includes, among other property listed therein: (1) all legal or equitable interests of the debtor in property; (2) all interests of the debtor and the debtor's spouse in community property; (3) property that the debtor acquires within 180 days after the petition date by bequest, devise, inheritance, as a result of an equitable distribution, or as the beneficiary of a life insurance policy; and (4) proceeds, product, offspring, rents, or profits of property of the estate. 11 U.S.C. § 541.

While Congress is conferred the exclusive right to establish uniform bankruptcy laws, the bankruptcy courts will look to non-bankruptcy law to determine property rights. See e.g. In re Merritt Dredging Company, Inc., 839 F.2d 203, 206 n. 1 (4th Cir. 1988) (citing seminal case of Butner v. United States, 440 U.S. 48, 54, 99 S.Ct. 914, 917-918, 59 L.Ed.2d 136 (1979)); and FCX, 853 F.2d at 1153. As explained by the Fourth Circuit,

[d]espite [§ 541's] broad definition of those interests of the debtor that become property of the estate, . . . , neither § 541(a), nor any other Bankruptcy Code provision, answers the threshold questions of whether a debtor has an interest in a particular item of property and, if so, what the nature of that interest is. . . . The estate under § 541(a) succeeds only to those interests that the debtor had in property prior to the commencement of the bankruptcy case. . . . The existence and nature of a debtor's, and hence the estate's, interest in property must be determined by resort to nonbankruptcy law, . . . either federal law, . . . or . . . state law.

FCX, 853 F.2d at 1153 (citations omitted) (citing, inter alia, Moody v. Amoco Oil Co., 734 F.2d 1200, 1213 (7th Cir. 1984) (“[W]hatever rights a debtor has in property at the commencement of the case continue in bankruptcy – no more, no less.”)).

In addition to the property listed in 11 U.S.C. § 541, in an individual Chapter 11 case, property of the estate further will include: (1) all property of the type set forth in § 541 which the debtor acquires after the commencement of the case, but before the case is closed, converted, or dismissed; and (2) earnings from services performed by the debtor

after commencement of the case, but before the case is closed, converted, or dismissed.
11 U.S.C. § 1115(a).

C. The Trustee’s “Strong Arm” Powers .

A bankruptcy trustee (and through 11 U.S.C. § 1007, a DIP) is deemed, as of the petition date, to have the rights of: (1) a judicial lien creditor with a perfected judgment lien on all assets of the debtor; and (2) a bona fide purchaser for value (“BFP”) of real property without regard to the trustee’s actual knowledge of any outstanding claim against the real property.³ 11 U.S.C. § 544. These avoidance powers are the main tools of a trustee in avoiding unperfected claims against property of the estate. However, while the trustee’s status as a BFP or judicial lien creditor is bestowed by federal law, the effect of that status with respect to other claims in any particular property of the estate is determined by state law. See e.g., Mahaffey, 91 F.3d 131, 1996 WL 383922, *3-*4; and Suggs, 355 B.R. at 527.

D. The Automatic Stay.

The filing of a bankruptcy petition “operates as a stay, applicable to all entities The purpose of the automatic stay, in addition to protecting the relative position of creditors, is to shield the debtor from financial pressure during the pendency of the bankruptcy proceeding. . . . The automatic stay is one of the fundamental debtor protections provided by the bankruptcy laws. It gives the debtor a breathing spell from its creditors. It stops all collection efforts, all harassment, and all foreclosure actions. It permits the debtor to attempt a repayment or reorganization plan, or simply to be relieved of the financial pressures that drove him into bankruptcy.

McMahon v. George Mason Bank, 94 F.3d 130, 133 (4th Cir. 1996) (citations omitted).

³ While the trustee is not charged with any actual knowledge the trustee may have regarding pre-existing claims in real property, a trustee’s status as a BFP is subject to whatever constructive notice is imposed by state law. See In re Mahaffey, 91 F.3d 131, 1996 WL 383922, *3-*4 (4th Cir. 1996) (unpublished); and In re Suggs, 355 B.R. 525, 527 (Bankr. M.D.N.C. 2006) (finding that trustee’s status as BFP is subject to constructive notice, and that, under North Carolina law, a lis pendens filed of record pre-petition defeated trustee as BFP).

As its name suggests, the automatic stay arises as a matter of course upon the filing of the bankruptcy petition without further order of the Court. Section 362(a) enumerates the matters prohibited by the automatic stay, including: (1) the commencement or continuation of any action or proceeding against the debtor that was or could have been commenced before the commencement of the case, to recover any claim against the debtor; (2) the enforcement of a judgment against the debtor or against property of the estate; (3) any act to obtain possession of property of the estate or to exercise control over property of the estate; (4) any act to create, perfect, or enforce a lien against property of the estate or against property of the debtor; (5) any attempt to collect a pre-petition debt from the debtor; and (6) the setoff of any debts owing between the debtor and the creditor.⁴

Certain matters are excepted from the automatic stay. 11 U.S.C. § 362(b). Among acts excepted from the stay are any acts to perfect or maintain the perfection of liens where the trustee's rights and powers under § 546(b) would be subject to such perfection. 11 U.S.C. §§ 362(b)(3). Section 546(b) states that the trustee's strong arm powers under § 544 are subject to "any generally applicable law that . . . permits perfection of an interest in property to be effective against an entity that acquires rights in such property before the date of perfection."

1. Relief from the Automatic Stay.

⁴ Setoff, which is prohibited by the automatic stay, should be distinguished from recoupment, which is not prohibited by the automatic stay. Powell v. FELRA and UFCW Health and Welfare Fund, 284 B.R. 573, 575 (Bankr. D. Md. 2002) (citing First National Bank of Louisville v. Master Auto Service Corp., 693 F.2d 308, 310 n.1 (4th Cir. 1982)). Generally, setoff involves mutual obligations arising out of different transactions, while recoupment contemplates mutual obligations arising out of the same transaction. Nevertheless, recoupment can be strictly construed, and a single contract can contemplate a series of transactions. See Ravenwood Healthcare, Inc. v. State of Maryland, 2007 W.L. 1657421 (D. Md. 2007) (slip opinion) (discussing differing tests for determining whether mutual obligations constitute setoff or recoupment).

The court may grant relief from the automatic stay. Section 362(d) authorizes the Court to grant relief from the automatic stay, and provides in relevant part:

On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay --

(1) for cause, including the lack of adequate protection of an interest in property of such party in interest;

(2) with respect to a stay of an act against property under subsection (a) of this section, if –

- (A) the debtor does not have any equity in the property; and
- (B) such property is not necessary for an effective reorganization

11 U.S.C. § 362(d).

“Cause” under § 362(d)(1) is not defined in the Bankruptcy Code. “‘Cause’ has no clear definition and is determined on a case-by-case basis.” In re Conejo Enterprises, Inc., 96 F.3d 346, 352 (9th Cir. 1996) (citations omitted). “In determining whether cause exists, the bankruptcy court should base its decision on the hardships imposed on the parties with an eye towards the overall goals of the Bankruptcy Code.” In re C&S Grain Co., Inc., 47 F.3d 233, 238 (7th Cir. 1995).

The Bankruptcy Code imposes separate burdens of proof with respect to motions for relief from stay. “In a hearing . . . concerning relief from the stay . . . the party requesting such relief has the burden of proof on the issue of the debtor’s equity in the property; and . . . the party opposing such relief has the burden of proof on all other issues.” 11 U.S.C. § 362(g). Therefore, while the Courts require the movant initially to articulate some prima facie basis for “cause,” thereafter, the ultimate burden lies with the debtor to prove the absence of “cause.” See In re Abdul Muhaiman, 343 B.R. 159, 169-

170 (Bankr. D. Md. 2006) (“The party seeking relief from the automatic stay has an initial burden of going forward with the evidence to establish *prima facie* cause for relief; but the burden of proof, i.e. the burden of persuasion, then shifts to the party opposing relief on all issues, except the existence of equity. This burden of persuasion may also be viewed as the risk of non-persuasion.” [internal citations omitted].); In re Highcrest Management Co., Inc., 30 B.R. 776, 778 (Bankr. S.D.N.Y. 1983) (where the debtor rests without presenting any evidence as to cause, the debtor has failed to carry its burden, and the stay should be modified); and In re Gauwin, 24 B.R. 578, 580 (9th Cir. BAP 1982) (the debtor has the burden to show the absence of cause).

a. **Relief from the Automatic Stay To Continue State Court Litigation.**

A line of case law has developed with respect to granting relief from stay to continue state court litigation in particular. While the term “cause” is not defined in the Bankruptcy Code, but only illustrated, the legislative history and the numerous cases since 1978 have made it abundantly plain that relief from the stay to pursue state court litigation was contemplated by Congress. As the Fourth Circuit has observed, the legislative history states as follows:

‘It will often be more appropriate to permit proceedings to continue in their place of origin, when no great prejudice to the bankruptcy estate would result, in order to leave the parties to their chosen forum and to relieve the bankruptcy court from many duties that may be handled elsewhere.’

In re Robbins, 964 F.2d 342, 345 (4th Cir. 1992) (quoting S.Rep. No. 95-989, at 50 (1978)).

The case law which has evolved under Section 362(d) has led to a series of different formulations as to the key factors which should be considered by the bankruptcy

court when deciding whether to allow pre-petition litigation to continue. Some courts have developed detailed lists of factors drawn from a review of prior decisions granting relief from stay to continue litigation in another forum. See, e.g., In re Countryside Manor, Inc., 188 B.R. 489 (Bankr. D. Conn. 1995) (identifying 12 different factors to be considered and lifting the stay to permit pending litigation to determine creditors' claims of fraud, theft and conversion); In re Touloumis, 170 B.R. 825 (Bankr. S.D.N.Y. 1994) (identifying 12 factors and lifting the stay to permit state court to determine issues of debtor's interest in property).⁵

Other courts have attempted to identify the core issues that are present in all cases where the court must decide whether to permit litigation to proceed in another forum. These courts have developed much shorter, more generalized, lists of factors. See, e.g. In re Kansas Psychiatric Institutes, Inc., 186 B.R. 723, 728 (Bankr. D. Kan. 1995) (identifying five factors); In re Milne, 185 B.R. 280 (N.D. Ill. 1995); In re Continental Airlines, Inc., 152 B.R. 420 (D. Del. 1993).

The Fourth Circuit has offered its own formulation, which generally directs a pragmatic determination as to which forum is better suited to resolve the underlying controversy, with consideration being given to the potential disruption to the bankruptcy court from hearing a complex trial based on non-bankruptcy law.⁶ In In re Robbins the Fourth Circuit considered:

⁵ Because these cases have drawn their lists from a myriad of different contexts, the list of factors are not reflective of the facts in any single case, and it is recognized that relief from the automatic stay may still be appropriate even when many or most of the factors are not present in a particular case. In re Sonnax Industries, Inc., 907 F.2d 1280, 1285 (2nd Cir. 1990) (considering the advanced stage of the state court litigation).

⁶ The issues consider not just the burden upon the bankruptcy court's calendar, but also the familiarity of the non-bankruptcy court with state law, the familiarity of that court with the already pending case, the

(1) whether the issues in the pending litigation involve only state law, so the expertise of the bankruptcy court is unnecessary; (2) whether modifying the stay will promote judicial economy and whether there would be greater interference with the bankruptcy case if the stay were not lifted because matters would have to be litigated in the bankruptcy court; and (3) whether the estate can be protected properly by a requirement that creditors seek enforcement of any judgment through the bankruptcy court.

In re Robbins, 964 F.2d at 345.

The third factor in Robbins, that any judgment be enforced solely in the bankruptcy court, is enforced in virtually every instance by the bankruptcy courts. The common denominator in these formulations is the search for the most efficient and effective forum, and one which protects both the debtor and is fair to the movant.

E. Priority Claims vs. Secured Claims.

The Bankruptcy Code categorizes unsecured claims into various priorities for distribution. These priorities are listed in 11 U.S.C. § 507(a), and include in descending order of priority: (1) certain domestic support obligations; (2) cost of administration claims allowed under § 503(b);⁷ (3) ordinary course of business expenses of the debtor arising during the “involuntary gap” period between the filing of an involuntary petition and the entry of an order for relief; (4) certain pre-petition employee wages; (5) certain pre-petition employee benefits; (6) certain expenses related to grain production; (7)

burden and expense to the movant if it were required to re-start its case in a new forum, and whether the non-bankruptcy court has jurisdiction over parties not before the bankruptcy court.

⁷ 11 U.S.C. § 503(b) provides for various costs of administration, including attorneys’ fees and expenses for the debtor and the official committee of unsecured creditors, post-petition obligations of the debtor or the trustee that benefit the estate, and other actual and necessary costs and expenses of preserving the estate. See In re D.M. Kaye & Sons Transport, Inc., 259 B.R. 114, 119-120 (Bankr. D. S.C. 2001) (to qualify as a cost of administration claim, debt must arise out of transaction with the trustee or the DIP and must substantially benefit the estate). The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (Pub. L. No. 109-8) (“BAPCPA”) added a first-priority claim category for certain domestic support obligations, thereby demoting cost of administration claims under allowed § 503(b) to second-priority claims under § 507(a).

limited deposits by consumers for goods; (8) certain taxes; (9) certain commitments to Federal depository institutions; and (10) claims for death or personal injury arising out of drunken driving. Unsecured claims not listed in § 507(a) constitute general unsecured claims which are not accorded priority by the Bankruptcy Code.

It is important to understand the distinction between priority claims and secured claims. Where a creditor has a lien on property of the estate, the creditor is a secured creditor, but may have no “priority” whatsoever. When a claim is secured by property of the estate, it is considered a secured claim “to the extent of the value of such creditor’s interest . . . in . . . [the collateral] . . . , and is an unsecured claim to the extent that the value of such creditor’s interest [in the collateral] . . . is less than the . . . [the total amount of the creditor’s] allowed claim.” 11 U.S.C. § 506(a). While a secured creditor is entitled to receive either its collateral or the value of its collateral under various provisions of the Bankruptcy Code, see e.g. 1129(b)(2)(A)(i)(II) and 1325(a)(5), any deficiency claim the creditor may have constitutes a general unsecured, non-priority claim unless the creditor’s claim independently is entitled to priority under the provisions of 11 U.S.C. § 507.

1. Reclamation Rights in Bankruptcy.

Prior to BAPCPA, former § 546(c)(2) provided that a party holding a valid reclamation claim either was entitled to a return of the reclaimed goods or to be treated as a secured or § 503(b) priority claimant. BAPCPA modified the rights and time periods during which a seller may assert reclamation rights under state law. First, the section now only provides that the trustee’s (and the debtor-in-possession’s) rights are subject to the rights of a seller to reclaim goods. There no longer is any provision granting a lien or priority treatment for a reclamation claim. Second, a seller of goods now may assert a

reclamation claim within 45 days after the debtor's receipt of the goods, or if the 45-day period expires after the petition filing, within 20 days after the petition filing. 11 U.S.C. § 546(c). However, this right, as it was pre-BAPCPA, still will be subordinate to the prior-perfected blanket liens of other secured creditors. See In re FCX, 62 B.R. 315 (Bankr. E.D.N.C. 1986) (reclamation rights are cutoff by prior-perfected blanket lien); and 11 U.S.C. 546(c)(1) (reclamation right is "subject to the prior rights of a holder of a security interest in such goods"). In addition, the reclamation creditor must prove that, at the time the Debtor received the demand, it still had possession of the goods. This is a difficult burden to meet. In most cases, contested reclamation claims will not be worth the cost of pursuing. However, merely giving notice of such a claim usually can be done with little cost and may result in an unchallenged claim.

b. Cost of administration claim for sellers of goods.

Despite its removal of the requirement to grant a lien or priority claim to a creditor with an allowed reclamation claim, BAPCPA nevertheless added a new presumptive cost of administration claim for goods delivered to the debtor immediately prior to the petition date. 11 U.S.C. § 503(b)(9) now provides that a creditor will be allowed a cost of administration claim to the extent of the "value of any goods received by the debtor within 20 days before the date of the commencement of a case under this title in which the goods have been sold to the debtor in the ordinary course of such debtor's business." Therefore, when representing a supplier to the debtor, it is important to file a timely motion for allowance of a cost of administration claim for the value of any goods received by the debtor within 20 days of the petition date, in addition to asserting any lien rights or other rights to which the creditor additionally may be entitled. This

cost of administration claim is available whether or not the creditor asserts a right to reclamation. 11 U.S.C. § 546(c)(2).

F. Executory Contracts.

Executory contracts are afforded special treatment under the Bankruptcy Code. A contract is an executory contract if, on the petition date, “the ‘obligations of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete the performance would constitute a material breach excusing the performance of the other.’” See e.g., RCI Technology Corp. v. Sunterra Corp., 361 F.3d 257, 264 (4th Cir. 2004) (quoting Gloria Mfg. Corp. v. Int’l Ladies’ Garment Workers’ Union, 734 F.2d 1020, 1022 (4th Cir. 1984)). Section 365 of the Bankruptcy Code specifically governs executory contracts.

1. General concepts regarding executory contracts.

11 U.S.C § 365 governs the treatment of executory contracts. Dealing with executory contracts in any bankruptcy case requires an understanding of this section and several important general concepts arising in connection therewith.

a. The Debtor’s/Trustee’s Options with regard to Executory contracts.

Upon the filing of a bankruptcy petition, the trustee (or the DIP) in a Chapter 11 case) has several options with regard to any particular executory contract. The trustee or DIP may:

- (1) assume the contract under § 365(a) and (b)(1)-(b)(3);
- (2) assume and assign the contract under § 365(f)(1)-f(3);⁸ or

⁸ Any provision in an executory contract, or in applicable law, that prohibits the assignment of the contract is invalid pursuant to 11 U.S.C. § 365(f)(1).

(3) reject the contract.

“Once a contract is assumed, it will continue to operate according to its terms. [citations omitted]. If the contract is rejected, the rejection gives rise to a claim for damages as if the contract had been breached pre-petition.” In re Dehon, 352 B.R. 546, 558-559 (Bankr. D. Mass. 2006).

Although there are some cases indicating to the contrary, the majority of cases put the debtor in an extremely beneficial position pending assumption or rejection. “[D]uring the period in which the debtor has neither accepted nor rejected the contract, the terms of the contract are temporarily unenforceable against the debtor.” Allied Fire & Safety Equipment Co., Inc. v. Dick Enterprises, Inc., 972 F.Supp. 922, 928 (E.D. Penn. 1997) (citing In re University Medical Center, 973 F.2d 1065, 1075 (3rd Cir. 1992)). Despite the unenforceability against the debtor, the majority of courts allow the debtor to enforce the terms of the contract against the non-debtor during this period. “After a debtor commences a Chapter 11 proceeding, but before executory contracts are assumed or rejected under § 365(a), those contracts remain in existence, *enforceable by the debtor but not against the debtor.*” United States Postal Service v. Dewey Freight System, Inc., 31 F.3d 620, 624 (8th Cir. 1994); see also In re El Paso Refinery, L.P., 220 B.R. 37 (Bankr. W.D. Tex. 1998) (“From the moment of filing to the moment of assumption or rejection, the non-debtor party is held to be barred from enforcing the contract and its terms.”); but see In re Tirenational Corp., 47 B.R. 647, 651 (Bankr. N.D. Ohio 1985) (“Until such time as the Court specifically allows the Debtor-In-Possession to reject a contract it continues to be effective and enforceable between the parties.”).

In a Chapter 11, the trustee or DIP has until confirmation of the plan to decide whether to assume or reject an executory contract unless otherwise ordered by the court at the request of any party to the contract. 11 U.S.C. § 365(d)(2). A party can move to compel the debtor to assume or reject a contract prior to the presumptive statutory deadline. Whether to establish a deadline for the debtor to assume or reject is within the discretion of the bankruptcy court. See Theater Holding Corp. v. Mauro, 681 F.2d 102, 105 (2nd Cir. 1982).

In determining what constitutes a reasonable time within which a debtor should assume or reject a contract, the court considers a number of factors, including: 1) the nature of the interests at stake; 2) the balance of the hurt to the litigants; 3) the good to be achieved; 4) the safeguards afforded those litigants; and 5) whether the action to be taken is so in derogation of Congress' scheme that the court may be said to be arbitrary. In re Dunes Casino Hotel, 63 B.R. at 949 (citations omitted). Most importantly, however, “the court should interpret reasonable time consistent with the broad purpose of Chapter 11, which is 'to permit [the] successful rehabilitation of debtors.’” Id. (quoting NLRB v. Bildisco & Bildisco, 465 U.S. 513, 104 S.Ct. 1188, 79 L.Ed.2d 482 (1984)).

In re G I Holdings, Inc., 308 B.R. 196, 213 (Bankr. D. N.J. 2004).

(i) **Assumption of an executory contract.**

A contract cannot be assumed by implication or action by the debtor without a court order approving the assumption. Dehon, 352 B.R. at 560. “Even where the non-debtor party to a contract continues to provide services under the contract and the debtor continues to accept the benefits of such performance, the contract will not be considered to have been assumed absent an order of the court approving the assumption.” Id. In addition to a motion to assume or reject an executory contract, an executory contract can be assumed under the terms of a confirmed Chapter 11 plan. 11 U.S.C. § 1123(b)(2).

Whether seeking authority to assume a contract by motion or pursuant to the terms of a Chapter 11 plan, in order to assume an executory contract, prior to assumption, a trustee or DIP must:

- (1) cure, or provide adequate assurance that it will promptly cure, any monetary default under the contract;
- (2) compensate the non-debtor party for any pecuniary losses arising from the default (which can include attorneys' fees); and
- (3) provide adequate assurance of future performance under the contract.

11 U.S.C. § 365(b)(1). If the trustee or DIP can meet these three pre-requisites, the court usually will defer to the trustee's/DIP's business judgment in determining whether to approve the assumption or rejection of a contract. See e.g. In re Armstrong World Industries, Inc., 348 B.R. 136, 162 (D. Del. 2006).

A contract must be assumed or rejected as a whole. AGV Productions, Inc. v. Metro-Goldwyn-Mayer, Inc., 115 F.Supp.2d 378, 390-391 (S.D.N.Y. 2000) (a debtor cannot cherry pick which sections of a contract it wants to assume and which it wants to reject). Only where non-bankruptcy law allows a contract to be severable will a debtor be entitled to assume or reject each severable portion. See e.g. In re Convenience USA, Inc., 2002 WL 230772 (Bankr. M.D.N.C. 2002).

(ii) Assignment of an executory contract.

Assignment of an executory contract is a two-step process. A trustee can assign a contract only if it is first assumed pursuant to 11 U.S.C. § 365(b)(1), meeting the prerequisites for such assumption as set forth above. See 11 U.S.C. § 365(f) (“trustee may assign an executory contract . . . only if . . . the trustee assumes such contract . . . in accordance with the provisions of this section”); see also In re James Cable Partners, 27 F.3d 534, 538 n. 8 (11th Cir. 1994) (quoting 11 U.S.C. § 365(f)). “Assignment by the

trustee [or the DIP] to an entity of a contract . . . assumed under . . . [§ 365(b)(1)] relieves the trustee and the estate from any liability for any breach of such contract . . . occurring after such assignment.” 11 U.S.C. § 365(k).

In order to assign a contract, in addition to meeting the requirements for assumption set forth above, the trustee or DIP also must provide adequate assurance of future performance by the assignee. 11 U.S.C. § 365(f)(2)(B).

(iii) **Rejection of an executory contract.**

Generally, rejection of the contract does not act as a termination of the contract, but merely is deemed to be a breach of the contract, which breach is deemed to have occurred immediately prior to the petition date. See In re Park, 275 B.R. 253, 256 (Bankr. E.D. Va. 2002). Generally, this pre-petition breach results in a general unsecured claim for the amount of damages caused by the breach.

b. **Executory contracts are protected by the automatic stay.**

Any attempt to terminate an executory contract post-petition is an attempt to control property of the estate, and is therefore prohibited by the automatic stay. In re Enron Corp., 300 B.R. 201, 212 (Bankr. S.D.N.Y. 2003) (and cases cited therein).

c. **The filing of a bankruptcy case does not constitute a default which will permit the termination of a contract by the non-debtor.**

Section 365(e)(1) provides that an executory contract may not be terminated or modified post-petition solely because of the filing of the bankruptcy or the insolvency of the debtor, and that contract provisions to the contrary are invalid and unenforceable.

d. **If the contract is effectively terminated pre-petition, the filing of a bankruptcy petition cannot resurrect it.**

While a debtor may assume an executory contract pursuant to § 365, there still must be a viable contract as of the petition date that is subject to assumption. If the contract has been effectively terminated pre-petition, there is nothing for the debtor or the trustee to assume, the court cannot resurrect the contract, and the automatic stay will not protect the contract. In re Estep, 173 B.R. 126, 131 (Bankr. N.D. Ohio 1994).

e. **Where a pre-petition notice of termination provides an opportunity to cure and the cure period has not expired as of the petition date, the contract will be protected by the automatic stay.**

Where the non-debtor party gives notice of termination prior to the petition date, but either the notice, the contract, or applicable non-bankruptcy law provide the debtor with a right to cure any default after receiving such a notice and the period within which the cure must occur has not expired as of the petition date, the bankruptcy petition will prevent the termination of the contract even if the debtor has not acted post-petition to cure the default by the end of the cure period. See Moody v. Amoco Oil Co., 734 F.2d 1200, 1215-1216 (7th Cir. 1984); and In re Tudor Motor Lodge Associates Ltd. Partnership, 102 B.R. 936, 949-950 (Bankr. D. N.J. 1989). Nevertheless, if all that remained for the contract to be terminated as of the petition date was the passage of time and the debtor did not have the right to cure during the notice period to prevent termination, the filing of the bankruptcy petition will not prevent automatic termination of a contract by the running of time. Moody, 734 F.2d at 1213 (“Section 362 does not give a debtor greater rights in a contract.”).

f. **Real Property Leases.**⁹

1. **Specific Issues With Respect to “Non-Residential” Real Property Leases**

a. **What is “Non-Residential” Real Property?**

(i) **Majority Position.** If any part of the real property is used for residential purposes, whether the real property is a commercial property or not, it is not “non-residential” real property. See e.g. In re Historical Locus Street Development Associates, 246 B.R. 218, 223 (Bankr. E.D. Penn. 2000) (and cases cited therein).

(ii) **Minority Position.** If the character of the lease is commercial, then the lease is a lease of “non-residential” real property. See e.g. In Sonora Convalescent Hospital, Inc., 69 B.R. 134, 136 (Bankr. E.D. Cal. 1986).

b. **Time Limits Regarding Assumption or Rejection**

(i) New Code Section 365(d)(4) Provides as follows:

(4)(A) Subject to subparagraph (B), an unexpired lease of non-residential real property under which the debtor is the lessee shall be deemed rejected, and the trustee shall immediately surrender that non-residential real property to the lessor, if the trustee does not assume or reject the unexpired by the lease by the earlier of –

(i) the date that is 120 days after the date of the order for relief, or

(ii) the date of the entry of an order confirming a plan.

Under the prior version of § 365(d), the debtor only had 60 days within which to assume or reject a lease for non-residential real property. The new provisions extend that period from 60 to 120 days, or until confirmation, if confirmation occurs within 120 days

⁹ The portion of this manuscript regarding real property leases previously was presented by Benjamin A. Kahn at the annual Middle District of North Carolina Bankruptcy Seminar on May 18-19, 2007, entitled “Various Issues Related to the Treatment of Non-Residential Real Estate Leases in Bankruptcy, Including BAPCPA Revisions.”

of the petition date.

(ii) **Extensions are Limited.** Previously, the debtor could obtain extensions of the 60 day time limit under former § 365(d)(4) upon a showing of “cause,” without a limitation as to the number or length of extensions. Pursuant to § 365(d)(4)(B), however, the court now may extend the deadline for 90 days. The section does not limit the extension to a single instance. Therefore, it appears that the court conceivably could enter multiple extensions as long as the aggregate time of those extensions does not exceed 90 days. Any additional extensions only can be granted with the written consent of the lessor.

(a) **Timeliness of motion to extend.**

New § 365(d)(4)(B) provides:

(B)(i) The Court may extend the period determined under subparagraph (A), prior to the expiration of the 120-day period, for 90 days on the motion of the trustee or lessor for cause.

(ii) If the court grants an extension under clause (i), the court may grant a subsequent extension only upon prior written consent of the lessor in each instance.

Section 365(d)(4)(B)(i), provides that an order extending the time to assume or reject must be entered within 120 days from the petition date. Despite the seemingly clear indication by the statute that the order itself must be entered within 120 days of the petition date, whether the actual order extending the period must be entered, or whether only the motion requesting an extension must be filed, within 120 days of the petition date is not clear. Compare In re Victoria Station, Inc., 840 F.2d 682 (9th Cir. 1988) (where motion to extend is filed on the last day, the court was free to extend the time thereafter because the court is not restricted by the deadline), with In re Tubular Technologies, LLC, 348 B.R. 699, 708-709 (Bankr. S.C. 2006) (finding that the

provisions of BAPCPA make clear that an extension only can be granted if the order doing so is entered within 120 days of the petition date).

Prior to the passage of BAPCPA, the majority of courts held that only the motion must be filed prior to the deadline, but that the order extending the time could be entered after the time period expired. See e.g., Legacy Ltd. V. Channel Home Centers Inc., 989 F.2d 682 (3rd Cir. 1993). The court in Tubular implies that BAPCPA has changed this result, despite the similar language between the pre-BAPCPA provision (“or within such additional time as the court, for cause, within such 60-day period, fixes . . .”) (emphasis added)), and the post-BAPCPA language set forth above.

(b) **Effect of confirmation on ability of court to extend time to assume or reject.**

Since paragraph (B)(i) requires that the order be entered prior to the expiration of the 120 day period, rather than prior to the expiration of the time to assume or reject, which under § 365(d)(4)(A), would be less than 120 days from the petition date if confirmation has occurred within that period, the language of the statute implies that the court may enter an order extending the time to assume or reject even after confirmation, or may extend the time to assume or reject to a date after confirmation. See COLLIER ON BANKRUPTCY (15th Ed. Rev.), ¶ 365.04(4) (“By referring to subparagraph (A), rather than to ‘the 120-day period,’ as the statute does later in the same clause, a court might conclude that either the deadline in subparagraph (A) – 120 days after the order for relief or the entry of a confirmation order – may be extended. Such a reading would permit the court to extend the deadline for 90 days after the entry of the confirmation order.”)

This outcome arguably would be contrary to the spirit of the deadlines to assume

or reject all types of executory contracts under § 365(d). Section 365(d)(2) permits a debtor to assume or reject an executory contract other than a lease of non-residential real property at any time before confirmation of a plan unless the court orders the debtor to determine whether to assume or reject such a contract in a shorter time. In an effort to protect lessors of non-residential real property, § 365(d)(4) shortens this time period to 120 days after the order for relief unless the Court extends that period as set forth herein. Nowhere in the previous provisions of the Code was the court permitted to extend the sixty-day time period under § 365(d)(4) beyond confirmation, and the BAPCPA revisions were intended to give landlords more certainty, encourage debtors to make a prompt decision, and to limit the bankruptcy court's discretion in granting multiple extensions. See In re Tubular Technologies, LLC, 348 B.R. 699, 708 (Bankr. S.C. 2006).

It certainly would be anomalous for the general provisions of § 362(d)(2) to require action prior to confirmation with respect to other executory contracts, but then to find that § 362(d)(4), which shortens the general time within which a Debtor may assume or reject non-residential real property leases, empowers the court to permit assumption outside the limit for the more liberal general provisions of § 365(d).

Despite the policy and Code provision arguments to the contrary, plans frequently provide for, and some courts have permitted, the debtor to assume or reject a lease for non-residential real property (along with other executory contracts) after the confirmation date. See In re Convenience USA, Inc., Case No. 01-81478 (Jointly Administered) (Bankr. M.D.N.C. 2003) (February 12, 2003 Order Confirming Debtors' Amended Joint Plan of Reorganization Under Chapter 11), p. 13 ¶ 36c. and pp. 38-39, ¶¶ 103-107) (allowing assumption to be conditioned upon post-confirmation events).

(c) **Excusable Neglect.**

The majority of courts find that the court cannot extend the time under § 365(d)(4) after its expiration pursuant to Rule 9006 due to excusable neglect. See Tubular Technologies, 348 B.R. at 710 (and cases cited therein); but see In re Chira, 343 B.R. 361 (Bankr. M.D. Fla. 2006) (in a pre-reform case, finding that Rule 9006 may be applied if a motion to extend previously has been granted).

(iii) **When is rejection effective?**

The courts are split as to whether rejection is effective as of the date of the motion seeking approval, or only after entry of the order on such a motion. Compare In re Fleming Companies, Inc., 304 B.R. 85, 96 (Bankr. Del. 2003) (normally, effective date of rejection is the date of the entry of an order approving such rejection, and citing In re Amber's Stores, Inc., 193 B.R. 819, 825-826 (Bankr. N.D. Tex. 1996), for the proposition that this is the majority position); with In re Spiess Company, 145 B.R. 597, 600-601 (Bankr. N.D. Ill. 1992) (Rejection requires two actions, first the filing of a motion, and second the entry of an order approving the (already accomplished) rejection. The motion effects the rejection, and the Code “treats court approval not as a condition precedent to an effective assumption or rejection, but rather as a safeguard subjecting the decision of the trustee (and its business judgment) to review and possible reversal.”).

(a) **Can the court approve retro-active rejection?**

The clear majority of courts hold that the bankruptcy court has the equitable powers to allow rejection to be effective nunc pro tunc to the date of the motion requesting approval for the rejection. See e.g. In re Thinking Machines Corporation, 67 F.3d 1021 (1st Cir. 1995). However, retro-active effectiveness is considered to be an

exceptional remedy. Fleming, 304 B.R. at 96 (citing In re Valley Media, 2003 W.L. 21956410 (Bankr. Del. 2003), for proposition that such relief is “extraordinary”).

c. Requirements Pending Assumption or Rejection.

Section 365(d)(3) provides:

The trustee shall timely perform all the obligations of the debtor . . . arising from and after the order for relief under any unexpired lease of nonresidential real property, until such lease is assumed or rejected, notwithstanding section 503(b)(1) of this title. (emphasis added).

This section clearly subjects the Trustee to a mandate regarding performance. Nevertheless, it does not provide any remedy if the Trustee fails to perform. Due to this ambiguity and others, many debates have arisen out of the section, including: (1) to what remedy is the lessor entitled if the trustee does not perform; (2) to what priority is the right to payment entitled in the event of a conversion; (3) assuming that the remedy is to allow an administrative claim, how is such a claim asserted; (4) assuming that the remedy is to allow an administrative claim, when must such a claim be paid; and (5) when does an obligation “arise” under the lease? In In re Midway Airlines Corporation, 406 F.3d 229 (4th Cir. 2005), the Fourth Circuit answered the first four of these questions in the context of the identical requirements imposed by the Code with respect to commercial equipment leases under former § 365(d)(10) (currently § 365(d)(5)).¹⁰ See also Ian J. Flanagan, Fourth Circuit Finds Middle Ground: A Compromise Between Lessors and Lessees to Recover Post-Petition Lease Obligations for Personal Property, 5 DePaul Bus.

¹⁰ After Midway and pursuant to BAPCPA, § 365(d)(10) was re-codified as § 365(d)(5). Former § 365(d)(10) shall be referred to hereafter under its current codification. In addition, while the Fourth Circuit in Midway was interpreting personal property leases pursuant to § 365(d)(5), the court expressly makes clear throughout the opinion that its analysis and holding apply equally to non-residential real property leases under § 365(d)(3). See e.g., Midway, 406 F.3d at 235 (considering and discussing § 365(d)(3) and § 365(d)(5) cases equally); and id. at 239 (“[s]ome courts following the majority view have concluded that § 365(d)(3) and (by analogy) § 365(d)(5) . . .”).

& Comm. L.J. 159 (Fall 2006).

a. **What is the remedy for a lessor when the trustee fails to perform?**

Two distinct lines of cases have developed regarding the remedy for the trustee's failure to perform. The first (and majority position) is that the lessor is entitled to an administrative expense claim independent of § 503(b), due to the language in §§ 365(d)(3) and 365(d)(5) providing that the trustee must perform the obligations of the lease "[n]otwithstanding section 503(b)(1) of this title." See Midway, 406 F.3d at 235 (and cases cited therein). The minority position holds that § 365(d)(3) does not entitle the unpaid lessor to an administrative expense claim absent the lessor availing itself of the other remedies under the Code, such as relief from stay, or the filing of a motion for allowance of a claim pursuant to § 503(b)(1), in which case the lessor must demonstrate that its unpaid post-petition rent was an actual and necessary expense of the estate. Id.

The Fourth Circuit agrees with the majority line of cases that the lessor is entitled to an administrative expense, notwithstanding the fact that the obligation under the lease may not be an actual and necessary expense of the estate as required by § 503(b)(1). However, the Fourth Circuit rejects the majority's conclusion that such a claim is independent of § 503(b). The Fourth Circuit concludes that § 365(d)(5) and (by analogy) § 365(d)(3) allow the recovery of an administrative claim pursuant to § 503(b), but that such a claim is independent only of § 503(b)(1), rather than being independent of § 503(b) as a whole. Therefore, the claimant does not need to prove that the expense was an actual and necessary expense of the estate. Id. at 236-237. By meeting the requirements of § 365(d)(3), the claim has fulfilled the prerequisites for allowance of an administrative claim under the general provisions of § 503(b). Id. at 237 (the right to

payment arises post-petition, and “the consideration supporting payment provides some benefit to the estate (the estate uses, or has the opportunity to use, the property)”.

b. Since the claim is allowed under § 503(b), it retains its priority in the event of conversion.

As observed by the Fourth Circuit, the majority’s rationale creates a conflict between the allowance of the claim independent of § 503(b) and the effects of § 348(d), which provides that “[a] claim against the estate or the debtor that arises after the order for relief but before conversion . . . other than a claim specified in section 503(b) of this title, shall be treated for all purposes as if such claim had arisen immediately before the date of the filing of the petition.” Therefore, if, as the majority concludes, § 365(d)(3) creates an administrative claim independent of § 503(b), then such a claim would not be entitled to keep its administrative status post-conversion. The Fourth Circuit finds this problem solved by concluding that the obligations of §§ 365(d)(3) and (d)(5) create an administrative claim under § 503(b). Id. at 238-239.

c. The claim is allowed after notice and opportunity for a hearing.

The Fourth Circuit rejects the conclusion of some of the majority courts that the obligations under the lease “constitute administrative expenses without notice and a hearing.” Id. at 239. Instead, by concluding that § 365(d)(3) does not operate independent of § 503(b), the Fourth Circuit observes that the procedural framework for asserting a claim pursuant to this section already is in place. Therefore, the lessor must file a motion for allowance of the claim after notice and a hearing. Id. at 239-240.

d. The timing of payment is in the discretion of the bankruptcy court.

Prior to Midway, the majority view held that a claim under § 365(d)(3) is entitled

to payment in the same priority and manner as other administrative claims. See e.g. In re Ames Department Stores, Inc., 306 B.R. 43 (Bankr. S.D.N.Y. 2004). A distinct minority held that such obligations created a “super-priority” because the mandates of § 365(d)(3) clearly require an obligation for immediate payment. Therefore, even if the case ultimately proves to be administratively insolvent, then § 365(d)(3) claims which already have been paid have received a de facto super-priority over other unpaid administrative expenses. See e.g. In re Duckwall-ALCO Stores, Inc., 150 B.R. 965 (D. Kan. 1993).

The Fourth Circuit sides with the majority. Id. at 241. After concluding that the lessor must “stand in line with other administrative claimants,” id. (quoting In re Joseph C. Spiess Co., 145 B.R. 597, 607-608 (Bankr. N.D. Ill. 1992)), the Fourth Circuit considered when payment on administrative claims must be made. The court concluded that the timing of payment is in the discretion of the bankruptcy court, stating:

While an administrative expense under § 503(b) must be paid in cash on the effective date of the plan in a chapter 11 proceeding, see 11 U.S.C. § 1129(a)(9)(A), and must be paid first upon a distribution of the assets in a chapter 7 proceeding, see 11 U.S.C. § 726(a)(1), bankruptcy courts have wide latitude in deciding whether to order payment prior to these deadlines. “In most situations the courts prefer to postpone payment of the administrative claim until confirmation of a plan or the distribution in a liquidation. However, once a claimant has requested payment, the court may exercise its discretion whether the circumstances warrant immediate response.” Accordingly, the decision whether to order immediate payment of administrative expenses allowed pursuant to § 365(d)(10) and § 503(b) is left to the discretion of the bankruptcy court.

Id. at 242 (citation omitted).

e. **When does an obligation “arise” under the lease?**

An ambiguity is created when an obligation of the lease, usually the obligation to pay rent or taxes, comes due under the terms of the lease either immediately pre-petition or immediately post-petition, but the obligation covers a period spanning both the pre and

post-petition periods. The Fourth Circuit has not addressed this issue in a published opinion. Again, two distinct lines of cases have emerged.

The first line of cases stems from the decision in In re Handy Andy Home Improvement Centers, Inc., 144 F.3d 1125 (7th Cir. 1998). In Handy Andy, Judge Posner concluded that tax obligations which came due post-petition, but covered both pre and post-petition periods, should be pro-rated between the pre-petition period and post-petition period on an accrual bases, rather than strictly adhering to the due date under the lease. Id. at 1127-1128.

The second line of cases develops a “bright-line” rule based upon the date that the obligation comes due under the terms of the lease. If the obligation comes due pre-petition, it is a pre-petition claim, whether it covers rent or taxes for a mostly post-petition period or not. The Third, Sixth and Ninth Circuits each have adopted this bright-line rule. See In re Montgomery Ward Holding Corp., 268 F.3d 205 (3rd Cir. 2001); In re Koenig Sporting Goods, Inc., 203 F.3d 986, 989 (6th Cir. 2000); and In re Cukierman, 265 F.3d 846, 847 (9th Cir. 2001).

In the Middle District of North Carolina, Judge Carruthers has sided with Judge Posner, adopting the pro-ration rule. In In re E-Z Serve Convenience Sotres, Inc., 2003 W.L. 21145800 (Bankr. M.D.N.C. 2003), Judge Carruthers held that ad valorem taxes should be pro-rated between the pre and post-petition periods. In E-Z Serve, the debtor filed its petition on October 4, 2002. On October 11, 2002, the lessor paid ad valorem taxes on the property for the 2002 tax year, and this payment triggered the obligation by the debtor to pay this amount to the landlord under the terms of the lease. Thereafter, the lease was rejected on November 26, 2002. The lessor argued that the entire amount of

taxes should be allowed as an administrative claim pursuant to § 365(d)(3) since it “arose” post-petition. The trustee and the committee argued that the taxes only were allowed administrative priority for that portion attributable to the post-petition, pre-rejection period. Judge Carruthers agreed with Handy Andy, and concluded that the taxes should be pro-rated. Id. at *3. In so concluding, Judge Carruthers additionally noted that the Fourth Circuit had reached the same result in an unpublished opinion. Id. (citing In re Roses Stores, Inc., 1998 W.L. 393984 (4th Cir. 1998)).

(i) **How is “stub rent” affected by the pro-ration and bright line rules?**

“Stub rent” arises when the occupancy period for which rent becomes due under the terms of the lease spans over both pre and post-petition periods. For example, if the rent became due on the first of the month, and the petition were filed on the fourth, the period from the fourth to the end of the month would be the stub rent period. Similarly, if the petition is filed on the ninth, but the rent for that month is not due until the tenth, the stub rent period runs from the petition date to the end of the month. As a practical matter, stub rent usually arises when the rent has become due under the terms of the lease immediately pre-petition. This distinction can be very important, as discussed below.

Most cases applying the bright line rule hold that, even if the stub rent is not entitled to administrative priority by operation of § 365(d)(3), the lessor still can receive an administrative claim for rent covering the stub period pursuant to § 503(b)(1) to the extent that the debtor’s occupancy is an actual and necessary expense of the estate. See e.g. In re ZB Company, Inc., 302 B.R. 316 (D. Del. 2003).

At least one court subject to the precedent of the pro-ration rule has come to a seemingly surprising conclusion regarding stub rent. In In re UAL Corporation, 291 B.R.

121 (Bankr. N.D. Ill. 2003), Judge Wedoff distinguished Handy Andy, and held that the stub rent was an entirely pre-petition obligation under § 365(d)(3) when the rent came due immediately pre-petition. In UAL, various leases provided that the rent for the month of December, 2002, came due on December 1, 2002. Id. at 123. The petition was filed December 9, 2003. Id. Post-petition, the debtor remained current on its rent under the leases for January, 2003, forward, but had not paid any portion of the December rent. Id. The debtor sought an extension of time within which to assume or reject the leases pursuant to former § 365(d)(4), and the lessors objected based upon debtor's failure to remain current for the entire post-petition period, including the stub rent period. Id. In apparent conflict with the rationale under Handy Andy, Judge Wedoff found that the rental due date under the lease was the pivotal fact in determining the status of the stub rent under § 365(d)(3). Id. at 125. He distinguished Handy Andy by observing that the taxes in Handy Andy, although covering both pre and post-petition periods, did not come due until post-petition. However, in this case, the rent came due pre-petition. Therefore, the debtor could not possibly "timely perform" the obligation post-petition as required by § 365(d)(3), and Judge Wedoff held that the rent should be treated as wholly pre-petition under § 365(d)(3). Id. at 126-127. Despite finding that the stub rent obligation was wholly pre-petition for purposes of § 365(d)(3), Judge Wedoff also sided with those bright-line cases finding that the rent for the stub period could, nevertheless, be entitled to priority pursuant to § 503(b)(1). Id. at 127.

f. What is the effect of rejection?

The courts are hopelessly split on whether rejection of a non-residential lease effects a termination of the lease, or merely constitutes a breach of the lease pursuant to § 365(g). In In re Park, 275 B.R. 253, 256 (Bankr. E.D. Va. 2002), the court observed that

“[t]he effect of rejection is one of the great mysteries of bankruptcy law.” (quoting In re Henderson, 245 B.R. 449, 453 (Bankr. S.D.N.Y. 2000)). The court observed the well-accepted general rule that rejection constitutes solely a breach, rather than a termination, of an executory contract. Id.

However, with respect to non-residential real property, the court in Park concludes that the additional requirement in § 365(d)(4) for the debtor to immediately surrender the property “necessarily implies a termination of the leasehold estate.” Id. at 257. In so holding, the court states that it is following the majority rule, and it does appear that the weight of authority agrees with the court’s holding. Id. (numerous cases cited therein, including Cromwell Field Associates, LLP v. May Department Stores Company, 5 Fed. Appx. 186, 2001 W.L. 208501 (4th Cir. 2001), in which the Fourth Circuit, in an unpublished opinion, states “in the . . . context of a nonresidential lease in which the tenant must immediately surrender possession upon rejection, the rejection of the lease is also a termination of the lease”); see also Harvest Corp. v. Riviera Land Co., 868 F.2d 1077 (9th Cir. 1989).

Nevertheless, the majority of circuit courts to consider the issue have concluded that rejection does not constitute termination, even in the context of non-residential real property leases. See Eastover Bank for Savings v. Austin Development Co., 19 F.3d 1077 (5th Cir. 1994), cert. denied, 115 S.Ct. 201 (1994) (breach of lease does not mean lease is terminated); In re Continental Airlines, 981 F.2d 1450 (5th Cir. 1993); Leasing Service Corp. v. First Tennessee Bank National Ass’n, 826 F.2d 434 (6th Cir. 1987); and In re Modern Textile, Inc., 900 F.2d 1184 (8th Cir. 1990). See also Michael T. Andrews, Executory Contracts Revisited: A Reply to Professor Westbrook, 62 U. Col. L. Rev. 1

(1991) (arguing that rejection is not termination).

g. BAPCPA’s effect on treatment for damage claims arising out of rejection of a lease when that lease previously was assumed by the debtor.

In an effort to strike a balance between requiring the debtor to act sooner in making the determination whether to assume or reject a non-residential real property lease and the potentially drastic effect on the estate and creditors that might arise out of a debtor’s forced premature assumption of a long-term lease, Congress enacted § 503(b)(7), which limits the potential exposure of the estate by providing a limit on the administrative claim of the lessor as follows:

with respect to a nonresidential real property lease previously assumed under section 365, and subsequently rejected, a sum equal to all monetary obligations due, excluding those arising from or relating to a failure to operate or a penalty provision, for the period of 2 years following the later of the rejection date or the date of actual turnover of the premises, without reduction or setoff for any reason whatsoever except for sums actually received or to be received from an entity other than the debtor, and the claim for remaining sums due for the balance of the term of the lease shall be a claim under section 502(b)(6)

h. BAPCPA’s effect on the remaining unsecured claim.

A landlord may argue that its allowed unsecured claim under § 502(b)(6) should be calculated based upon the entire amount due under the lease as of the date of rejection and without regard to the amount of the allowed administrative claim under § 502(b)(7). Such an argument appears to be contrary to the language of § 502(b)(7), which provides that the claim under § 502(b)(6) applies to “remaining sums due . . .” after allowance of the administrative claim.

i. BAPCPA’s effect on the requirement to cure non-monetary obligations upon assumption.

Previous § 365(b)(1) required the debtor to cure all defaults under the lease, but §

365(b)(2)(D) excepted from that cure requirement those defaults arising from “the satisfaction of any penalty rate or provision relating to a default arising from any failure by the debtor to perform non-monetary obligations under the . . . lease.” Prior to BAPCPA, a split in the circuits had developed regarding the proper interpretation of this provision.

The Ninth Circuit held that the debtor must cure all non-monetary defaults pursuant to § 365(b)(1), whether those defaults were curable or not, and that § 365(b)(2)(D) only excepted penalty provisions from the cure requirement. Therefore, where the debtor was in default under a continuous operation provision, which default obviously could not be cured retroactively, the debtor was prevented from assuming the lease. In re Claremont Acquisition Corp., Inc., 113 F.3d 1029, 1030 (9th Cir. 1997). The First Circuit rejected the Ninth Circuit’s holding as too harsh. The First Circuit went to the opposite extreme and held that the debtor did not have to cure any non-monetary defaults. In re BankVest Capital Corp., 360 F.3d 291 (1st Cir. 2004).

Congress sided with the Ninth Circuit in requiring the cure of non-monetary defaults and limiting the exception to the cure requirements provided by § 365(b)(2)(D) solely to penalty provisions. However, Congress agreed with the First Circuit that preventing the debtor from assuming a lease solely due to a prior non-monetary default which was not impossible to cure was too harsh. Therefore, new § 365(b)(1)(A) provides that, prior to assumption, in addition to curing monetary defaults, the trustee must cure a default:

other than a default . . . arising from any failure to perform nonmonetary obligations under an unexpired lease of real property, if it is impossible for the trustee to cure such default by performing nonmonetary acts at and after the time of assumption, except that if such default arises from a

failure to operate in accordance with a nonresidential real property lease, then such default shall be cured by performance at and after the time of assumption in accordance with such lease, and pecuniary losses resulting from such default shall be compensated in accordance with the provisions of this paragraph

Therefore, the debtor no longer is prevented from assuming the lease by a prior non-monetary default, even if that prior default is impossible to cure retroactively. However, if the default is due to a failure to operate in accordance with the terms of the lease, from an after assumption, the debtor must comply with the operation requirements of the lease, and the landlord, as part of the cure payment(s) is entitled to receive any pecuniary damages caused by the debtor's pre-assumption failure to operate. Section 365(b)(2)(D) continues to except penalty rates and provisions from the debtor's cure obligations.

II. The General Progression of a Chapter 11 Case.

A. First Day Motions

Most Chapter 11 cases will commence with the filing of a number of first day motions. In a reorganization case, these motions typically include: 1) motions to employ counsel or other professionals for the debtor; 2) a motion to continue to use debtor's pre-petition bank accounts;¹¹ 3) a motion to continue to debtor's employee benefit plans; 4) a motion to pay pre-petition employee wages; and 5) an emergency motion to use cash collateral. In some cases, the Debtor will file emergency motions to sell property of the estate, or to obtain post-petition financing ("DIP Financing"). These motions usually are heard on an expedited basis. While some of these motions are routine, and usually have little impact on the case or the debtor's estate, DIP Financing motions and cash collateral

¹¹ The bankruptcy courts in the Middle District require new DIP accounts to be established.

motions in particular affect important rights. Therefore, it is important to be vigilant and, if necessary, pro-active from the inception of a Chapter 11 case.

1. Use of Cash Collateral

If a trustee or DIP is authorized to conduct business,¹² it may use property of the estate in the ordinary course of the debtor’s business without court approval.¹³ There is an exception to this general rule, however. The Bankruptcy Code places special restrictions on the use of “cash collateral.” Cash collateral is defined as “cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents . . . in which the state and an entity other than the estate have an interest and includes the proceeds, products, offspring, rents, or profits of property” 11 U.S.C. § 363(a).

The trustee or DIP cannot use cash collateral unless each entity that has an interest in the cash collateral consents, or the court authorizes the use of cash collateral after notice and a hearing. If the debtor intends to use cash collateral, it must provide the non-debtor entity with adequate protection of its interest in the cash collateral. 11 U.S.C. § 363(e). “Adequate protection” can be provided by cash payments, replacement liens in property of equal value, and other relief giving the creditor the “indubitable equivalent” of its interest in such property. 11 U.S.C. § 361.

In almost every Chapter 11 case, a debtor will file an emergency motion to use cash collateral on the first day of the case. This motion may be preliminarily heard on an expedited basis, with a final hearing scheduled at least fifteen (15) days after service of

¹² In a Chapter 7 case, the trustee must be authorized to conduct business by the court. 11 U.S.C. § 721. In a Chapter 11, unless otherwise ordered by the court, a debtor is authorized to conduct business without court order pursuant to the Bankruptcy Code. 11 U.S.C. § 1108.

¹³ In order to use or sell property of the estate outside the debtor’s ordinary course of business, the debtor must obtain approval by the bankruptcy court. 11 U.S.C. § 363(b).

the motion. At the preliminary hearing, the court is limited to authorizing the use of cash collateral only to the extent necessary to prevent irreparable harm to the estate, and, then, only if the creditors who have an interest in that cash collateral are adequately protected. 11 U.S.C. § 363(e) and Rule 4001(b)(2) of the Federal Rules of Bankruptcy Procedure (“Bankruptcy Rules”). Any non-debtor party asserting an interest in “cash collateral” of the debtor, including debtor’s accounts receivable or contract balances already paid, should carefully review any motion to use cash collateral and object if necessary to ensure that its interests are adequately protected.

In many cases, the debtor will enter consensual cash collateral orders with its lender. In these orders, the debtor typically will agree to a number of protections and concessions in exchange for the creditor’s consent to use of cash collateral. The Western District of North Carolina has enumerated many of these standard provisions in Appendix B to its Local Rules. As enumerated by the Western District of North Carolina, these provisions that the court generally will approve include: (a) granting adequate protection in the form of monthly payments and/or replacement liens on the same type of post-petition collateral and in the same priority as the creditor’s lien on similar pre-petition collateral; (b) granting the creditor a super-priority claim pursuant to 11 U.S.C. § 507(b) to the extent that the adequate protection proves inadequate; (c) providing for a segregated account into which cash collateral is deposited; (d) restricting the use of cash collateral to specific items; (e) requiring the debtor to maintain insurance; (f) requiring the submission of financial reporting to the creditor; (g) requiring equality of treatment with respect to carve-outs for professionals employed by the debtor and any creditors’ committee; and (h) providing that the order approving the use of cash collateral is itself sufficient proof

of the validity and priority of the creditor's liens and priority. In addition, these orders frequently provide a deadline for other parties to object to the secured creditor's liens and/or priority, and that any such objections are barred thereafter. Therefore, it is important for other creditors to be vigilant with respect to the proposed terms and findings in these orders.

4. Post-Petition Financing

Issues often arise concerning the debtor's desire to seek financing after the bankruptcy petition has been filed in order to finance continued operations. The debtor must obtain court approval before obtaining further secured lending to fund continued operations.

Section 364 of the Bankruptcy Code governs requests for such post-petition financing. Under 364(a), the trustee (or, more often, the debtor-in-possession standing in the shoes of the trustee) may obtain unsecured credit and incur unsecured credit in the ordinary course of business without prior approval of the court. In order to incur unsecured debt outside of the ordinary course of business, the bankruptcy court must approve the request. In either instance, the unsecured credit advanced is allowable as an administrative expense under section 503(b)(1).

In the event that the trustee is unable to obtain credit on those terms, Section 364(c) permits the court to authorize, after notice and a hearing, to obtain credit that: 1) has a "superpriority" over all other 503(b) and 507(b) administrative expenses; 2) is secured by a lien on property of the estate that is not otherwise subject to a lien; or 3) is secured by a junior lien on property of the estate that is already subject to a lien.

Section 364(d) permits the bankruptcy court to authorize the trustee to incur debt secured by a lien that is senior or equal to a lien already in place on property of the estate,

a so-called “priming lien.” Courts generally view the grant of a priming lien as “extraordinary” relief. In re Seth Co., 281 B.R. 150, 153 (Bankr. D. Conn. 2002) (quoting 3 Collier on Bankruptcy § 364.05 (15th ed. rev. 2002)). The Court may approve a priming lien for purposes of post-petition financing only if “(A) the trustee is unable to obtain such credit otherwise; and (B) there is adequate protection of the interest of the holder of the lien on the property of the estate on which such senior or equal lien is proposed to be granted.” 11 U.S.C. § 364(d)(1). The debtor-in-possession has the burden of proving that the creditor sought to be primed is adequately protected. Id. § 364(d)(2).

a. Issues Surrounding Priming Liens

Proposed post-petition financing arrangements where the debtor seeks to prime existing lienholders are usually the most contentious. Such arrangements are also generally subject to higher scrutiny by the bankruptcy court than other post-petition financing arrangements. See In re Mosello, 195 B.R. 277, 289 (Bankr. S.D.N.Y. 1996) (quoting In re First S. Savings Ass'n., 820 F.2d 700, 710 (5th Cir. 1987)) (“a court that is asked to authorize [a priming lien] must be particularly cautious when assessing whether the creditors so displaced are adequately protected”).

The proposal for adequate protection must be sufficient “to insure that the creditor receive the value for which he bargained prebankruptcy.” Id. at 288 (quoting In re Swedeland Dev. Group, Inc., 16 F.3d 552, 564 (3d Cir. 1994) (en banc)). “[T]he proposal should provide the pre-petition secured creditor with the same level of protection it would have had if there had not been post-petition superpriority financing.” Id. (quoting In re Swedeland, 16 F.3d at 564). The most “important question” in

determining adequate protection under 11 U.S.C. § 364(d)(1)(B) “is whether the interest of the secured creditor whose lien is to be primed is being unjustifiably jeopardized.” Id. at 289 (quoting In re Plabell Rubber Prods., Inc., 137 B.R. 897, 899 (Bankr. N.D. Ohio 1992)).

The authorization to prime an existing lien should not be read as authorization to increase substantially the risk of the existing lender in order to provide security for a new, post-petition lender. When the effect of the new borrowing with a senior lien is merely to pass the risk of loss to the holder of the existing lien, the request for authorization should be denied.

In re Windsor Hotel, L.L.C., 295 B.R. 307, 314 (Bankr. C.D. Ill. 2003) (citing 3 Collier on Bankruptcy § 364.05[1]).

Recent case law outside of the Fourth Circuit suggests that an equity cushion alone may not provide a secured creditor sufficient adequate protection when the debtor proposes to supplant the secured creditor's lien with a priming lien. See In re Swedeland, 16 F.3d at 566 (“continued construction based on projections and improvements to the property does not alone constitute adequate protection”); In re Windsor Hotel, L.L.C., 295 B.R. 307, 314 (Bankr. C.D. Ill. 2003) (citing In re Swedeland, 16 F.3d at 567) (“Congress did not contemplate that a secured creditor could find its position eroded and, as compensation for the erosion, be offered an opportunity to recoup dependant upon the success of a business with inherently risky prospects”).

The 3rd Circuit's en banc unanimous decision in Swedeland, in particular, rejected “the notion that development property is increased in value simply because a debtor may continue with construction which might or might not prove to be profitable.” 16 F.3d at 565. The Court intimated that adequate protection with respect to development property is possible “only when the improvements [are] made in conjunction with the debtor's

providing additional collateral beyond the contemplated improvements.” Id.

In In re Strug-Division LLC, 380 B.R. 505 (Bankr. N.D. Ill. 2008), the court rejected the debtor's attempt to obtain a priming lien in order to renovate an apartment complex. The court there noted that the equity cushion in the properties at issue was “eroding on a daily basis,” that the debtors were “trying to reorganize on a shoe-string budget,” and that “the potential success of the proposed . . . project [was] too speculative.” Id. Under those conditions, the Court found that where the only adequate protection offered was the “increase in property value resulting from the . . . work,” the proposed replacement lien could not provide adequate protection since the “increase in value [would] not bring total value to much more than the debt plus proposed loan.” Id. at 515.

The seminal case concerning priming liens in the Fourth Circuit is In re Snowshoe, 789 F.2d 1085 (4th Cir. 1986). In that case, a trustee, not a debtor-in-possession, sought a priming lien in order to fund continued operations of a ski resort that was in bankruptcy. The Fourth Circuit, although recognizing that other courts had held that an equity cushion “is part of the bargained for consideration and cannot itself protect the secured creditor,” id. at 1090, found that the district court below did not err in determining that the equity cushion in the resort property provided adequate protection for the priming lien. The Fourth Circuit emphasized, however, that, in addition to the equity cushion, the trustee had provided a detailed financial projection which indicated that the superpriority loan would likely be repaid in only one ski season. The court also indicated that because the estate was being administered by an experienced trustee, the trustee’s repayment projections were in themselves entitled to “some deference” that, by

implication, would not have been afforded to a debtor-in-possession.

The court in Snowshoe explicitly left open the question of whether an equity cushion alone would constitute adequate protection of the priming lien. In addition, Snowshoe was not a bankruptcy case involving a developer or development property. Thus, it is an open question whether the Fourth Circuit would recognize an equity cushion alone could adequately protect an existing lienholder from a priming lien in a developer bankruptcy or would instead follow the Swedeland line of cases in that circumstance.

B. Committees

1. Appointment

Section 1102 of the Bankruptcy Code authorizes the appointment of committees to represent the interests of various creditor constituencies in a Chapter 11 case. While the Bankruptcy Administrator¹⁴ may appoint committees representing other creditor constituencies, the Bankruptcy Administrator shall appoint a committee representing creditors holding general unsecured claims. 11 U.S.C. § 1102(a). Despite the mandatory language of this section with respect to the appointment of unsecured creditors' committees, no committee will be appointed if: (1) there is insufficient interest for service on the committee;¹⁵ or (2) if the debtor is a "small business"¹⁶ and the court orders that no committee be appointed. 11 U.S.C. § 1102(a)(3).

¹⁴ Section 1102 refers to the United States Trustee. In North Carolina, the Bankruptcy Administrator performs the functions of the United States Trustee.

¹⁵ The Bankruptcy Administrators in the three districts of North Carolina have slightly different procedures for determining whether to establish an unsecured creditors committee in any particular Chapter 11 case. Generally, the Bankruptcy Administrators contact some or all of the creditors listed on the debtor's petition as the twenty (20) largest unsecured creditors, and will appoint a committee if at least three (3) creditors timely respond that they are willing to serve.

Any entity appointed to the committee must be representative of the constituency represented by the committee. 11 U.S.C. § 1102(b)(1) and (2). In addition, an entity who is a “small business” creditor of the debtor may request that the court appoint it to an existing committee if the court determines that the small business creditor holds a claim of the type represented by the committee and the claim is disproportionately large with respect to the creditor’s annual gross revenues. 11 U.S.C. § 1102(b)(4).

2. Functions, powers, and duties of a committee.

(a) Employment of professionals.

A committee is authorized, upon approval by the court, to employ professional persons, including counsel for the committee and accountants, to represent and advise the committee in furtherance of its duties. 11 U.S.C. § 1103(a). The application for such approval is governed by Bankruptcy Rule 2014, which enumerates the required content of the application. Any professional employed by the estate also must file applications for compensation pursuant to 11 U.S.C. § 330 and Bankruptcy Rule 2016. Allowed compensation for any professionals is paid by the estate as a cost of administration claim pursuant to 11 U.S.C. §§ 503(b)(2) and 330(a)(1).

(b) Powers and duties of committees.

All members of a committee assume a fiduciary duty to all members of the class represented by the committee. In addition, pursuant to 11 U.S.C. § 1102(b)(3), a committee shall provide access to information to creditors who hold claims of the kind represented by the committee. Despite this provision, courts have placed limitations on

¹⁶ For purposes of this provision, a “small business” debtor is a debtor engaged in commercial or business activities that has aggregate noncontingent liquidated secured and unsecured debt as of the petition date of not more than \$2,190,000.00. 11 U.S.C. § 101(51D).

the requirements of disclosure. For example, committees may not be required to disclose information: (a) that is confidential or proprietary; (b) that could reasonably be determined to result in a general waiver of a privilege; or (c) whose disclosure could violate an agreement, order, or law, including securities regulations. See e.g., In re Refco, Inc., 336 B.R. 187 (Bankr. S.D.N.Y. 2006).

Pursuant to 11 U.S.C. § 1103(c), a committee may:

- (1) consult with the trustee or debtor in possession concerning the administration of the case;
- (2) investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business, and the desirability of the continuance of such business, and any other matter relevant to the case or to the formulation of a plan;
- (3) participate in the formulation of a plan, advise those represented by such committee of such committee's determination as to any plan formulated, and collect and file with the court acceptances or rejections of a plan;
- (4) request the appointment of a trustee or examiner under section 1104 . . . ; and
- (5) perform such other services as are in the interest of those represented.

In addition to the duties listed in 11 U.S.C. § 1103(c), 11 U.S.C. § 1109(b) specifically includes any committee as a "party in interest" with standing to raise issues and appear and be heard on any issue in a case.

C. Plans of Reorganization and Liquidation

1. Time limits for filing a plan and gaining acceptance of a plan.

Unless a trustee has been appointed, during the first 120 days after the order for relief, only the debtor may file a plan. 11 U.S.C. § 1121(b) and (c)(1). Any party in interest, including the debtor, the trustee, and a committee, may file a plan if : (a) a trustee has been appointed; (b) the debtor has not filed a plan within 120 days; or (c) the

debtor has not filed a plan that has been accepted before 180 days after the order for relief by each class of claims under the proposed plan. The court may extend the 120 day and 180 day limits (known as the “exclusivity period”), but the 120 day period to file a plan may not be extended beyond 18 months after the order for relief, and the 180 day period to gain acceptances may not be extended beyond 20 months.

2. Contents of a plan of reorganization.

Section 1123 of the Bankruptcy Code divides provisions of a plan into two categories: (1) those provisions that are required to be in a plan; and (2) those provisions that may be in a plan. Section 1123(a) sets forth the mandatory provisions by providing that a plan shall:

- (1) designate classes of claims;
- (2) specify whether each class is impaired;¹⁷
- (3) specify the treatment of each class;
- (4) provide for the same treatment for each claim within a particular class unless the holder of the claim consents to other treatment;
- (5) provide for adequate means for implementation of the plan, including transfer of property, merger, consolidation, sale of assets, satisfaction or modification of any lien, curing or waiving any default, re-amortization of a loan, altering the interest rate on a loan, amending the debtor’s charter, or issuing securities of the reorganized debtor;
- (6) prohibit in the debtor’s charter that any non-voting securities are issued, and provide for certain voting procedures for directors;
- (7) contain only provisions that are consistent with the interests of creditors, equity security holders, and with public policy with respect to the manner of selection of any officer, director, or trustee; and

¹⁷ Generally, 11 U.S.C. § 1124 provides that a class is an “impaired” class unless the plan leaves the legal, equitable and contractual rights of each claim in that class unaltered. If a plan proposes to cure any default, compensate the holder of the claim for any pecuniary loss caused by any default, and reinstate the maturity of an accelerated obligation, the claim will be unimpaired. 11 U.S.C. § 1124(2).

- (8) in cases in which the debtor is an individual, provide for the payment to creditors all of the individual's future income as is necessary for execution of the plan.

In turn, 11 U.S.C. § 1123(b) provides that the plan may:

- (1) impair or leave unimpaired any class of claims;
- (2) provide for the assumption of executory contracts;
- (3) retain or resolve any claims held by the estate;
- (4) provide for the sale of substantially all the property of the estate and the distribution of the proceeds;
- (5) modify the rights of holders of unsecured or secured claims, other than a claim secured only by a security interest in the debtor's principal residence; and
- (6) include any other appropriate provision not inconsistent with the applicable provisions of Chapter 11.

3. Solicitation and voting on a plan of reorganization.

The proposal and confirmation of a plan of reorganization or liquidation is the heart of the bankruptcy case.

a. Solicitation of a plan.

The proponent of a plan cannot solicit the acceptance of creditors with respect to the plan until the debtor has filed, and the court has approved after notice and hearing, a disclosure statement.¹⁸ 11 U.S.C. § 1125(b). A disclosure statement must contain a summary of the plan and “adequate information.”¹⁹ Id. “Adequate information” requires that the disclosure statement contain sufficient information and detail, including Federal tax consequences of any plan provision, so that a hypothetical investor of the relevant

¹⁸ In small business cases, the Bankruptcy Code provides for a different procedure, as discussed, infra., at Section II.D.

¹⁹ Attached hereto as Appendix A is a sample Disclosure Statement.

class is able to make an informed judgment about the plan. 11 U.S.C. § 1125(a)(1). It is assumed that the hypothetical investor has the same access to information from other sources as would any other member of the relevant class. 11 U.S.C. § 1125(a)(2). Disclosure statements are exempted from any laws and regulations regarding the offer, issuance, sale, or purchase of securities. 11 U.S.C. § 1125(d) and (e).

b. Voting and acceptance of a plan.

Once the disclosure statement has been approved by the court, the proponent is free to send copies of the disclosure statement and plan to creditors and to solicit acceptances of the plan. Any holder of an allowed claim under section 502 may vote to accept or reject a plan. 11 U.S.C. § 1126(a).²⁰

In order to gain acceptance by a class of claims, a plan proponent must receive accepting votes from: (a) more than one-half of the creditors holding claims in that class; and (b) creditors holding at least two-thirds of the amount of claims in that class. 11 U.S.C. § 1126(c). Nevertheless, any unimpaired class of claims is conclusively deemed to have approved the plan, 11 U.S.C. § 1126(f), and any class of claims or interests that is to receive no payments or property on account of their claims or interest is conclusively deemed to have rejected the plan. 11 U.S.C. § 1126(g).

²⁰ Section 502(a) provides that a claim is allowed if a proof of claim for the claim has been filed and no objection to the claim has been filed. To the extent that a claim is subject to a pending objection at the time of plan voting, the holder of the claim may file a motion with the court to temporarily allow the claim for purposes of voting on the plan. Bankruptcy Rule 3018(a). Temporary allowance is not dispositive as to the amount of the claim. See e.g., In re Armstrong, 295 B.R. 344 (10th Cir. B.A.P. 2003), aff'd, 97 Fed. Appx. 285 (10th Cir. 2004). The court may temporarily allow a claim in any circumstance justifying such allowance in its discretion, including where: (a) the objection thereto is frivolous or abusive; (b) fully considering the objection will delay the administration of the estate; or (c) the objection is filed too late to be heard prior to confirmation. Id.

4. Confirmation of a plan of reorganization.

There are two ways in which a plan can be confirmed by the court: (a) acceptance by every impaired class; or (b) “cram down” by the bankruptcy court.

a. Unanimous acceptance of a plan.

Section 1129(a) provides that a court shall approve a plan if all of the following requirements are met:

- (1) The plan complies with the applicable provisions of the Bankruptcy Code;
- (2) The proponent of the plan complies with the applicable provisions of the Bankruptcy Code;
- (3) The plan is proposed in good faith²¹ and not by any means forbidden by law;
- (4) Any payments to be made under the plan are approved by the court as reasonable;
- (5) The plan discloses the individuals who will serve after confirmation as officers, directors, or voting trustees, and it is in the best interests of the creditors, equity security holders, and public policy;

²¹ One court has explained the good faith requirement as follows:

A plan of reorganization cannot be confirmed unless it satisfies 11 U.S.C. § 1129(a)(3) which requires that the plan must be proposed in good faith and not by any means forbidden by law. The good faith provision of 11 U.S.C. § 1129(a)(3) is designed to “prevent abuse of the bankruptcy laws and protect jurisdictional integrity.”

The overriding standard for good faith within the meaning of 11 U.S.C. § 1129(a)(3) is whether “there is a reasonable likelihood that the plan will achieve a result consistent with the standards prescribed under the Code.” [citations omitted]. However, whether a plan is filed in good faith is a matter to be assessed in view of the totality of the circumstances which necessitated the plan, in perspective of the purposes of the Bankruptcy Code. [citations omitted]. Finally, it is necessary to keep in mind that reorganization under Chapter 11 was intended to afford the earnest debtor an opportunity to restructure its finances in such a fashion as to permit continued operation of business ventures so as to enable payment of creditors, rather than face immediate liquidation. Indeed, prompt payment of creditors is a primary objective of a Chapter 11 reorganization. [citations omitted]. Accordingly, the failure of a debtor to use the full reach of its disposable resources to repay creditors is evidence that a plan is not proposed in good faith because such conduct frustrates this objective.

In re Walker, 165 B.R. 994, 1000-1001 (E.D. Va. 1994).

- (6) If a government regulatory agency has control over the rates to be charged by the debtor post-confirmation, that agency has approved the rates in the plan;
- (7) Each holder of an impaired claim has accepted the plan or will receive value under the plan that is not less than the amount that creditor would receive if the debtor were liquidating under Chapter 7;
- (8) Each class of claims and interests has accepted the plan or is unimpaired.
- (9) All priority claims other than tax claims will be paid in full on the effective date, and all priority tax claims will be paid with interest over not more than five (5) years, unless the order of the claim agrees otherwise;
- (10) If any class is impaired, at least one impaired class has accepted the plan;
- (11) Confirmation of the plan is not likely to be followed by the liquidation or further reorganization of the debtor, unless such liquidation or further reorganization is proposed in the plan;
- (12) Certain fees have been paid as required by 28 U.S.C. § 1930, including filing fees and conversion fees;
- (13) The plan provides for the continuation of all retiree benefits as set by the bankruptcy court under 11 U.S.C. § 1114;
- (14) The debtor has paid all domestic support obligations arising post-petition;
- (15) In individual bankruptcy cases where the holder of an unsecured claim has objected to confirmation, the creditor will receive the amount of its claim, or the debtor proposes to distribute property pursuant to the plan in an amount equal to his disposable income over the next five (5) years;
- (16) All transfers of property of the plan shall be made in accordance with any applicable provisions of non-bankruptcy law that govern the transfer of property by a corporation or trust that is not a moneyed, business, or commercial corporation or trust.

b. Cram Down.

If all the requirements of 11 U.S.C. § 1129(a) are met except 11 U.S.C. § 1129(a)(8), i.e. unanimous acceptance by all impaired classes, the court may “cram down” the plan if the proponent meets the requirements of 11 U.S.C. § 1129(b). The vernacular term “cram down” is not found in the Bankruptcy Code. The use of the term

“cram down” to describe the process contemplated by 11 U.S.C. § 1129(b) is believed to come from the figurative idea that the court is cramming the plan down the unwilling creditor’s(s’) throat(s). See e.g., Shaw v. Aurgroup Financial Credit Union, 552 F.3d 447, 450-451 n. 3 (6th Cir. 2009) (referring to the similar concept of “cram down” in the context of confirmation of Chapter 13 plans).

If all the requirements for approval under 11 U.S.C. § 1129(a) are met other than acceptance by all impaired classes, then upon request of the plan proponent,²² the court shall confirm a plan “if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.” 11 U.S.C. § 1129(b)(1). (emphasis added)

Section 1129(b) defines the requirements for a plan to be “fair and equitable” with respect to classes as follows:

(a) Fair and Equitable Regarding Secured Claims – 1129(b)(2)(A). A plan is fair and equitable regarding a class of secured claims if: (i) the holders of claims within the class retain the liens securing their claims to the extent of their allowed secured claim, and the holder of each such claim receives payments or property with a current value of at least the amount of the value of the secured claim;²³ (ii) if the property is to be sold, the liens of the secured party transfer to the proceeds of the sale, and the liens in the proceeds are treated as required in paragraph (i) above or (iii) below; or (iii) the holders of each secured claim receive the “indubitable equivalent” of their claim under the plan.

²² The proponent must request cram down. See e.g., In re Townco Realty, Inc., 81 B.R. 707, 710 (Bankr. S.D. Fla. 1987) (request for cram down must be made at or before the confirmation hearing).

²³ The amount of an allowed secured claim is limited to the value of the collateral, with the balance being unsecured. 11 U.S.C. § 506(a).

(b) Fair and Equitable Regarding Unsecured Claims – 1129(b)(2)(B) (the “Absolute Priority Rule”). A plan is fair and equitable regarding a class of unsecured claims if the holder of each claim in that class receives property or payments of a value as of the effective date of the plan equal to the allowed amount of the claim, or all holders of any claim or interest that is junior in priority receive nothing on account of their junior claims or interests. It is important to understand this requirement when representing a single unsecured creditor. Under the language of 11 U.S.C. § 1129(b), cram down only must be determined to be fair and equitable with respect to any rejecting class. Therefore, if a class accepts the plan, a single creditor within that class cannot object to the plan on the basis of the absolute priority rule. See In re Adelfia Communications Corp., 544 F.3d 420, 426-427 (2nd Cir. 2008) (“a plan need not satisfy the Absolute Priority Rule so long as any class adversely affected by the variation [from the rule] accepts the plan”).

(c) Fair and Equitable Regarding Classes of Interests – 1129(b)(2)(C). The holder of an equity interest must receive: (i) the greatest of: (a) any fixed liquidation preference to which the holder is entitled; (b) any fixed redemption price to which the holder is entitled; or (c) the value of its equity; or (ii) all holders of any interest that is junior in priority must receive nothing on account of their junior interests.

5. Effect of confirmation of a plan of reorganization.

Confirmation: (a) binds the debtor, any entity issuing securities under the plan, any entity acquiring property under the plan, any creditor, any equity security holder, and any general partner of the debtor, whether or not they have accepted the plan; (b) vests all the property of the estate back into the debtor free and clear of all liens, claims, and interests except as provided under the plan; and (c) discharges the debtor from pre-

confirmation debts, unless: (i) the debtor is an individual and the debt is excepted from discharge under 11 U.S.C. § 523; or (ii) (A) the plan provides for a liquidation of all or substantially all of the property of the estate; (B) the debtor does not engage in business after consummation of the plan; and (C) the debtor would be denied a discharge under 11 U.S.C. § 727(a). 11 U.S.C. §§ 1141(a) through 1141(d).²⁴

If the debtor is an individual, and unless the court orders otherwise, confirmation does not discharge any debt until the court grants a discharge upon completion of all payments required under the plan. 11 U.S.C. § 1129(d)(5). Nevertheless, an individual may request that the court enter a discharge prior to completion of all payments under the plan if: (a) the debtor has made payments under the plan in an amount that is equal to what the creditors would have received if the case had been liquidated on the effective date; and (b) the debtor neither has been convicted of, nor is not the subject of a prosecution for, certain felonies as listed in 11 U.S.C. § 522(q)(1). 11 U.S.C. § 1141(d)(5).

D. Small Business Provisions

The Bankruptcy Code has a number of provisions that apply only to “small businesses.”²⁵

1. Duties of a Small Business Debtor.

The Bankruptcy Code imposes certain additional duties upon a small business debtor as follows:

²⁴ The most common effect of this section is that it prohibits a discharge of a liquidating debtor that is not an individual, i.e. a corporation.

²⁵ Generally, a “small business” debtor is a debtor engaged in commercial or business activities that has aggregate noncontingent liquidated secured and unsecured debt as of the petition date of not more than \$2,190,000.00. 11 U.S.C. § 101(51D).

- (a) The debtor must append to the petition, or in an involuntary case, file within 7 days, its most recent balance sheet, statement of operations, cash-flow statement, and Federal income tax return, or file a statement that no such documents have been prepared;
- (b) The debtor must attend, through its senior management, all meetings scheduled by the court and the Bankruptcy Administrator;
- (c) The debtor must timely file its schedules, and the court may not extend the period within which to do this beyond 30 days after the order for relief absent extraordinary circumstances;
- (d) The debtor must file all post-petition financial reports required by the Bankruptcy Code and Rules;
- (e) The debtor must maintain insurance customary and appropriate to its industry;
- (f) The debtor must timely file tax returns;
- (g) The debtor must allow the Bankruptcy Administrator's office to inspect its business premises and books.

11 U.S.C. § 1116.

2. Different Exclusivity Periods and Deadlines for Filing Plans.

Pursuant to 11 U.S.C. 1121(e)(1), the exclusive period for the debtor to file a plan in a small business case terminates 180 days after the order for relief. Regardless, any plan and disclosure must be filed within 300 days of the order for relief. 11 U.S.C. § 1121(e)(2). The court may extend either of these two time periods only if: (a) the debtor demonstrates by a preponderance of the evidence that it is more likely than not that the court will confirm a plan within a reasonable period of time; (b) a new deadline is established at the time the extension is granted; and (c) the order extending time is signed before the existing deadline expires.

3. Different Procedures for Disclosure Statement, Plan Solicitation, and Confirmation.

Pursuant to 11 U.S.C. § 1125(f), in the case of a small business, the court may determine that the plan provides adequate information and that a separate disclosure statement is not required. In addition: (a) the court may conditionally approve a disclosure statement without notice, subject to final approval after notice and hearing; (b) the plan proponent may solicit acceptances based upon that conditional approval; and (c) the hearing on the disclosure statement can be combined with the confirmation hearing. 11 U.S.C. § 1125(f)(3).²⁶ Finally, in a small business case, the court must confirm a plan no later than 45 days after the plan is filed, unless the debtor proves that the plan is likely to be confirmed within a reasonable time. 11 U.S.C. § 1129(e).

E. Conversion or Dismissal

Under 11 U.S.C. § 1112(a), a debtor may convert a case under Chapter 11 to a case under Chapter 7 at any time unless the debtor is not a debtor in possession, i.e. a trustee has been appointed, the case originally was commenced as an involuntary case, or the case was converted to Chapter 11 other than upon the request of the debtor.

Section 1112(b) provides that, upon motion by a party in interest, the court shall convert or dismiss a case, whichever is in the best interests of the creditors, for “cause,” unless the court specifically enumerates the bases of why conversion or dismissal is not in the best interests of the creditors. Section 1112(b)(4) lists the following non-exclusive bases as “cause” for conversion or dismissal:

- (A) substantial or continuing loss to or diminution of the estate and the absence of a reasonable likelihood of rehabilitation;

²⁶ The procedure for conditional approval of a disclosure statement is governed by Bankruptcy Rule 3017.1.

- (B) gross mismanagement of the estate;
- (C) failure to maintain appropriate insurance that poses as risk to the estate or to the public;
- (D) unauthorized use of cash collateral substantially harmful to 1 or more creditors;
- (E) failure to comply with an order of the court;
- (F) unexcused failure to satisfy timely any filing or reporting requirement;
- (G) failure to attend the meeting of creditors or an examination ordered by the court without good cause shown by the debtor;
- (H) failure to timely provide information or attend meetings reasonably requested by the Bankruptcy Administrator;
- (I) failure to timely pay taxes owed after the date of the order for relief;
- (J) failure to file a disclosure statement or to file or confirm a plan within the time fixed by the court;
- (K) failure to pay certain required fees;
- (L) revocation of an order of confirmation due to fraud;
- (M) inability to effectuate substantial consummation of a confirmed plan;
- (N) material default by the debtor with respect to a confirmed plan;
- (O) termination of a confirmed plan by reason of the occurrence of a condition specified in the plan; and
- (P) failure of the debtor to pay any post-petition domestic support obligation.

Filing a case in bad faith also is “cause” for dismissal. As explained by the United States Court of Appeals for the Fourth Circuit:

In this circuit, a lack of good faith in filing a Chapter 11 petition requires a showing of “objective futility” and “subjective bad faith.” *Id.* at 700-01. The objective test focuses on whether “there exists the ‘realistic possibility of an effective reorganization.’” See Carolin, 886 F.2d at 698 (quoting In re Albany Partners, Ltd., 749 F.2d 670, 674 (11th Cir. 1984)); *id.* at 701-702; see also In re Coleman, 426 F.2d 719, 728 (4th Cir. 2005). The subjective test asks whether a Chapter 11 petition is motivated by an honest intent to effectuate reorganization or is instead motivated by some improper

purpose. Carolin, 886 F.2d at 702. Subjective bad faith is shown where a petition is filed “to abuse the reorganization process,” or “to cause hardship or to delay creditors by resort to the Chapter 11 device merely for the purpose of invoking the automatic stay.” Id.

In re Premier Automotive Services, Inc., 492 F.3d 274, 279 (4th Cir. 2007). See also, In re Crown Financial, Ltd., 183 B.R. 719 (Bankr. M.D.N.C. 1995) (subjective bad faith is shown where the case is merely a two party dispute which can be resolved in state court).

CONCLUSION

Chapter 11 is an extremely complex process with a myriad of issues, deadlines, and procedures. This manuscript was written and is intended as a summary overview and to provide the reader with a general understanding of the Chapter 11 process. It is not intended to be a comprehensive list of all issues, procedures, and property rights that arise during any given Chapter 11 case. As with any issue arising in other bankruptcy chapters, a qualified bankruptcy practitioner should be consulted with respect to every Chapter 11 filing.

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE EASTERN DISTRICT OF NORTH CAROLINA
RALEIGH DIVISION

IN RE:

CHAPTER 11

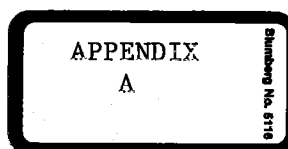
CASE NO. _____

Debtor.

DISCLOSURE STATEMENT PURSUANT TO
SECTION 1125 OF THE BANKRUPTCY CODE

_____, North Carolina
_____, 20__

THIS DISCLOSURE STATEMENT CONTAINS INFORMATION THAT MAY BEAR UPON
YOUR DECISION TO ACCEPT OR REJECT THE DEBTOR'S PROPOSED CHAPTER 11
PLAN FILED _____, 20__. PLEASE READ THIS DOCUMENT WITH CARE.



SUMMARY

The following summary is qualified in its entirety by the more detailed information appearing elsewhere in this Disclosure Statement and in the Debtor's Chapter 11 Plan, filed with the Bankruptcy Court on _____, 20__ (the "Plan"). All capitalized terms contained in this summary as well as elsewhere in this Disclosure Statement shall, unless otherwise defined herein, have the meaning ascribed to such capitalized terms in Article I, "DEFINITIONS", of the Plan. The words "herein", "hereof" and "hereunder" and other words of similar import used in the Disclosure Statement and in the Plan shall refer to the Plan as a whole and not to any particular article, section, subsection or clause contained herein or in the Plan. Wherever from the context it appears appropriate, each term stated in either the singular or the plural includes the singular and the plural, and pronouns stated in the masculine, feminine or neuter gender shall include the masculine, feminine, and the neuter.

The Debtor has prepared this Disclosure Statement in connection with its solicitation of acceptances or rejections of the Plan, which was filed with the Bankruptcy Court in connection with the Debtor's Chapter 11 case. The Plan was proposed by the Debtor.

The Bankruptcy Court will set a date for a hearing to consider whether, pursuant to Section 1125 of the Bankruptcy Code, this Disclosure Statement should be approved as containing information of a kind and in sufficient detail to enable a hypothetical, reasonable investor, typical of each of the classes of Creditors and each of the classes of Equity Interests being solicited, to make an informed judgment whether to vote or accept or reject the Plan. Such approval by the Bankruptcy Court does not constitute a recommendation of the Plan by the Bankruptcy Court. The Bankruptcy Court will hold a hearing on confirmation of the Plan, at which time the Bankruptcy Court will consider objections to confirmation, if any.

Objections to confirmation of the Plan, if any, must be in writing and served and filed as described below under the caption III, "CONFIRMATION".

The Plan proposes that the Debtor will continue to operate profitably and use the profits to fund its Plan. The Plan proposes to pay all Allowed Claims in full.

The Plan classifies Claims separately in accordance with requirements and provisions of the Bankruptcy Code and provides different treatment for each class of Claims. The Plan proposes that Claims and Equity Interests shall be classified as follows:

- Class 1 - Allowed Administrative Expense Claims
- Class 2 - Allowed Priority Tax Claims
- Class 2A-Allowed Secured Tax Claims
- Class 3 - Allowed Secured Claims of _____ Bank
- Class 4 – Remaining Allowed Claims
- Class 5 - Equity Interests

A Ballot to be used for voting to accept or reject the Plan has been enclosed with all copies of this Disclosure Statement mailed to Creditors and holders of Equity Interests whose Claims or Equity Interests are impaired by provisions of the Plan. Classes 2, 2A, 3, and 4 and

are Impaired. After carefully reviewing this Disclosure Statement and its exhibits, please indicate your vote on the enclosed Ballot.

To be counted, your Ballot must be received at the address listed below within the time frame set by the order of the Bankruptcy Court conditionally approving this Disclosure Statement.

_____[ATTORNEY FOR DEBTOR INFORMATION]_____

The foregoing is a summary. This Disclosure Statement and the exhibits hereto should be read in their entirety by Creditors and holders of Equity Interest before voting on the Plan.

INTRODUCTION

_____, debtor and debtor-in-possession in this chapter 11 case ("Debtor"), submits this Disclosure Statement pursuant to § 1125 of the Bankruptcy Code in connection with the solicitation of acceptances or rejections of the Debtor's Chapter 11 Plan dated [DATE], 20___. The purpose of this Disclosure Statement is to provide adequate information to enable Creditors to make an informed judgment as to whether or not to vote in favor of the Plan.

Any Claim with respect to which the legal, contractual, or equitable rights are altered, modified, or changed by the proposed treatment under the Plan is considered "impaired". Under the Plan, Allowed Claims in Classes 2, 2A, 3, and 4 are "impaired", and the Creditors holding such Claims are entitled to vote on the Plan, and may do so by completing the appropriate Ballot which is enclosed.

The vote of each Creditor is important. To be counted, your Ballot must be received by the time set by the order of the Bankruptcy Court approving this Disclosure Statement.

The Bankruptcy Code requires, as a condition to confirmation of a chapter 11 plan under § 1129(a) of the Bankruptcy Code, that each class of claims or interests which is impaired under such plan shall have accepted the plan. Under § 1126(c) of the Bankruptcy Code, a class of claims has accepted a plan if such plan has been accepted by creditors that hold at least two-thirds (2/3) in dollar amount and more than one-half (1/2) in number of the allowed claims of such held by creditors that have voted to accept or reject such plan. Under § 1126(d) of the Bankruptcy Code, a class of equity interests has accepted a plan if such plan has been accepted by holders of such interests that hold at least two-thirds (2/3) in amount of the allowed interests of such class held by holders of such interest that have voted to accept or reject such plan.

Section 1129(b) of the Bankruptcy Code permits the confirmation of a plan notwithstanding the nonacceptance of such plan by some of the classes of claims or interests impaired thereunder if (a) at least one impaired class of Claims votes to accept the plan and (b) the Bankruptcy Court finds that, with respect to the nonaccepting class or classes, the plan does not discriminate unfairly and is fair and equitable.

The Debtor is soliciting acceptance or rejection of the Plan by all Creditors whose Claims are impaired under the Plan. (See "III. CONFIRMATION" for a complete description of the requirements for acceptance of the Plan.)

No statement or information concerning the Debtor (particularly as to the liquidation of the Debtor, as to the results of operations or the financial condition of the Debtor, or as to distributions to be made under the Plan) or any of the respective assets or businesses of the Debtor is authorized other than as set forth in this Disclosure Statement, and no other such statement of information should be relied upon in determining how to vote with respect to the Plan.

I. GENERAL INFORMATION

A. Description of the Debtor's Business and Assets.

The Debtor operates a _____ in _____, North Carolina. The Debtor owns its building. At the time of the petition in bankruptcy, Debtor listed assets of \$ _____ and liabilities of at least \$ _____. As of this date, claims in the amount of \$ _____ have been filed with the bankruptcy court.

B. Events leading to the Chapter 11 Case.

The Debtor filed a previous Chapter 11 case on _____, 20___. The Bankruptcy Court confirmed a Chapter 11 Plan of Reorganization in that case on _____, 20__ and the case was closed on _____, 20___. Among other things, the confirmed Chapter 11 Plan provided that the debt to _____ Bank would be amortized over _____ years with a _____ year call. The Debtor was unable to make payment to _____ Bank following the _____ year call.

C. Preferential Payments made to Insiders and Non-Insiders.

1. **Transfers to Non-Insiders within Ninety Days.** The payments made by the Debtor within the 90 days prior to the bankruptcy are listed in the Debtor's Statement of Financial Affairs on file with the bankruptcy court.

2. **Transfers to Insiders within One Year.** The payments made by the Debtor to insiders within the one year prior to the bankruptcy are listed in the Debtor's Statement of Financial Affairs on file with the bankruptcy court.

D. Creditors= Committee.

No creditors' committee has been appointed in this case.

II. THE DEBTOR'S CHAPTER 11 PLAN

The Plan contemplates that the Debtor will continue to operate. The Debtor shall continue to pay all operating expenses incurred.

A. Summary of Classes and Treatment. The Plan provides for treatment of Claims in accordance with the following classes:

(a) Class 1 Claims - Allowed Administrative Expense Claims. Allowed Administrative Expense Claims (estimated to be comprised of attorney's fees and certified public accountant's fees) that exist on the Effective Date shall be satisfied on the Effective Date, or as otherwise may be agreed by the holder of such Allowed Administrative Expense Claim. Each Administrative Expense Claim that is disputed on the Effective Date shall be satisfied within thirty (30) Business Days after entry of a Final Order approving such Claim as an Allowed Administrative Expense Claim, or as otherwise may be agreed by the holder of an Allowed Administrative Expense Claim.

(b) Class 2 Claims - Allowed Priority and Secured Tax Claims. The Debtor has scheduled tax claims in the amount of \$_____. The Debtor is continuing to investigate other amounts which may be owed taxing authorities, and believes that the Class 2 claims could be significantly larger than the scheduled amount. Class 2 Claims shall be paid in full with interest at the rate set by Internal Revenue Code sections 6601 and 6621 in equal quarterly payments, so that the last payment shall be due within five years of the filing date. The first such payment shall be due on the later of the Effective date or _____, 20___. Holders of Class 2 claims shall be required to send quarterly statements showing the amount due under this Plan to the Debtor.

(c) Class 3 - Allowed Secured Claims of [BANK], N.A. Debtor shall continue to make its regular monthly payments to Class 3. Interest shall continue to accrue at the non-default contract rate and Class 3 shall retain its lien. Any payments in arrears on the Effective date shall be added to the end of the loan.

(d) Class 4 Claims - Allowed Unsecured Claims. The Debtor has scheduled unsecured claims in the amount of \$_____, with the majority of that amount being owed to [____]. Class 4 shall receive the following payments: The Debtor shall make quarterly payments to Class 4 with the first payment due on the later of _____, 20__ or the Effective Date. The amount of each payment shall be \$_____ less the payment made in that quarter to Class 2 (as an example, if \$_____ is paid to Class 2, then \$_____ shall be paid to Class 4). The quarterly payments shall continue until Class 4 has been paid a total of \$_____.

(e) Class 5 - Allowed Equity Interests in the Debtor. The existing equity interests in the Debtor shall be cancelled. On the Effective Date, [NAME] shall become the 100% owner of the new equity interest in the Debtor. In exchange for the new equity interest, [NAME] shall pay

\$ _____. The new equity interests shall not be subject to any options to purchase which may exist as to the pre-confirmation equity interests.

B. Release of the Debtor. The confirmation of the Plan shall constitute waiver and release of the right to pursue litigation and causes of action against the Debtor. Pursuant to Section 524(e) of the Bankruptcy Code, neither the Plan nor its confirmation affects the liability of any other Entity on, or the property of any other Entity for, any Claim treated by the Plan.

III. CONFIRMATION

A. Confirmation Hearing.

Section 1128 of the Bankruptcy Code requires the Bankruptcy Court after notice, to hold a confirmation hearing on the Plan at which time any party in interest may be heard in support of or opposition to confirmation. The Confirmation Hearing will be scheduled by the Bankruptcy Court by court order. The Confirmation Hearing may be adjourned from time to time without further notice except for an announcement made at the Confirmation Hearing. Any objection to confirmation must be made in writing and filed with: Clerk, U.S. Bankruptcy Court, Eastern District of North Carolina, Raleigh Division, P.O. Box 1441, Raleigh, North Carolina 27602-1441, as indicated in the order establishing the date for the confirmation hearing.

B. Confirmation Standards.

In order for a plan of reorganization to be confirmed, the Bankruptcy Code requires among other things, that a plan be proposed in good faith, and that a plan comply with the applicable provisions of Chapter 11 of the Bankruptcy Code. Section 1129 of the Bankruptcy Code also imposes requirements that at least one class of claims accept a plan, that confirmation of the plan is not likely to be followed by the need for further financial reorganization, that a plan be in the best interests of creditors, and that a plan be fair and equitable with respect to each class of claims of interest which is impaired under the plan. The Bankruptcy Court shall confirm a plan only if it finds that all of the requirements enumerated in section 1129 of the Bankruptcy Code have been met. The Debtor believes that the Plan satisfies all of the requirements for confirmation.

1. Best Interest Test. Before the Plan may be confirmed, the Bankruptcy Court must find (with certain exceptions) that the Plan provides, with respect to each Class, that each holder of a Claim or Equity Interest of such Class either (a) has accepted the Plan or (b) will receive or retain under the Plan on account of such Claim or Equity Interest, property of a value, as of the Effective Date, that is not less than the amount that such person would receive or retain if the Debtor were, on the Effective Date, liquidated under Chapter 7 of the Bankruptcy Code. The Debtor believes that this test will be satisfied because [].

2. Financial Feasibility. The Bankruptcy Code requires, as a condition to confirmation, that confirmation of a plan is not likely to be followed by the liquidation (unless the plan calls for liquidation) of the Debtor or the need for further financial reorganization. [].

3. Acceptance by Impaired Classes. The Bankruptcy Code requires as a condition to confirmation that each Class of Claims or Equity Interests that is impaired under the Plan accept

such Plan, with the exception described in the following section. A Class of Claims has accepted the Plan if the Plan has been accepted by creditors (other than insiders) that hold at least two-thirds (2/3) in dollar amount and more than one-half (1/2) in number of the Allowed Claims of such Class who actually vote to accept or to reject the Plan. A Class of Equity Interests has accepted the Plan if the Plan has been accepted by holders of Equity Interests (other than insiders) that hold at least two-thirds (2/3) in amount of the Allowed Equity Interests who fail to vote are not counted as either accepting or rejecting the Plan.

A Class that is not impaired under a Plan is deemed to have accepted such Plan; solicitation of acceptances with respect to such Class is not required. A Class is impaired unless (i) the legal, equitable and contractual rights to which the Claim or Equity Interest entitles the holder of such Claim or Equity Interest are not modified, or (ii) with respect to Secured Claims, the effect of any default is cured and the original terms of the obligation are reinstated.

4. Confirmation Without Acceptance by All Impaired Classes. The Bankruptcy Code contains provisions that would enable the Bankruptcy Court to confirm the Plan, even though the Plan has not been accepted by all impaired Classes, provided that the Plan has been accepted by at least one impaired Class of Claims.

Section 1129(b)(1) of the Bankruptcy Code states: "Notwithstanding section 510(a) of this title, if all of the applicable requirements of subsection (a) of this section other than paragraph (8) are met with respect to a plan, the court, on request of the proponent of the plan, shall confirm the plan notwithstanding the requirements of such paragraph if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan."

The Debtor believes that the Plan meets the 1129(b) test because the Debtor proposes to continue profitable operations. The Debtor believes that, if necessary, it will be able to meet the statutory standards set forth in the Bankruptcy Code with respect to the nonconsensual confirmation of the Plan.

C. Consummation.

The Plan will be consummated and distributions made if the Plan is confirmed pursuant to a Final Order of the Bankruptcy Court. It will not be necessary for the Debtor to await any required regulatory approvals from agencies or departments of the United States Government to consummate the Plan. The Plan will be implemented pursuant to its provisions and the provisions of the Bankruptcy Code.

V. ALTERNATIVE TO THE PLAN

A. Liquidation.

If no Chapter 11 plan can be confirmed, the Chapter 11 Case will be dismissed or converted to case under Chapter 7 of the Bankruptcy Code, in which case a trustee would be elected or appointed to liquidate the assets of the Debtor for distributions to Creditors in accordance with the priorities established by the Bankruptcy Code. Alternatively, the Debtor's Chapter 11 Case could be dismissed.

The Debtor recommends that holders of Claims and Equity Interests vote to accept the Plan.

Dated: Raleigh, North Carolina
[DATE], 20__

Respectfully submitted,

[DEBTOR]

[NAME], President

State Bar No.: _____
Attorney for Debtor

Telephone: _____