American Bankruptcy Board of Certification  
Sample Exam  
Business Bankruptcy Subspecialty  
Answer Two Question of Three Questions  
Total Time – Three Hours

NOTE: The following questions and sample answers are based upon a question used in past examinations. In this portion of the sample, both the questions and the sample answers have been updated to reflect the present state of the law. The questions give an idea of the likely scope and subject matter of the questions you will see. Although an excellent paper would discuss in some detail all of the issues raised in the sample answer, a paper may receive a passing grade even though the analysis is less thorough. The sample answers are often far more detailed than a test-taker’s answer will be, in order to reflect all the issues that one might discuss. Historically, more than 90 percent of the papers have received a passing score.

Business Subspecialty Essay  
Question A  
(Suggested Time - 1 1/2 hours)

Martin Financial Printers, Inc. (MFP) filed a Chapter 11 petition on January 2, 2017. MFP is a financial printing company and has been in the financial printing business for over eighty years. It is a privately held corporation whose stock is owned equally by four individuals - - Joan Mead, Tamar Venter, Joseph Gerten, and Arielle Zorne. Mead, Venter, Gerten, and Zorne also serve as the principal officers and as directors of MFP.

In December 2012, MFP obtained a five-year term loan of $5 million from FirstBank to provide working capital for the business. Under the terms of the loan, MFP was obligated to pay interest only on a quarterly basis at prime + 2 points and to repay the principal in December 2017. MFP last paid interest on the loan on October 7, 2016. At the time the loan was made in 2012, the bank took a security interest in all of MFP's inventory and equipment, now owned and hereafter acquired. Unfortunately, through an oversight, the bank failed to file financing statements to perfect its interest until after it performed a troubled loan review in November of 2016. On November 18, 2016, the bank filed U.C.C. financing statements with the Secretary of State where MFP was located.

In September of 2015, MFP borrowed $2 million from CPI Finance Co. The loan was provided on an unsecured basis but was guaranteed by Mead, Venter, Gerten and Zorne. Under the terms of the loan, MFP was required to pay 12% interest to CPI on the 15th day of each month and was required to repay $1 million of the principal on September 1, 2016, and the other $1 million of principal on September 1, 2017. However, CPI was entitled to demand repayment earlier if it deemed itself insecure.

In 2016, MFP’s business substantially declined. By late in the summer of 2016, the principals of MFP began to realize that the company was in severe financial difficulty. Cash flow was insufficient to cover MFP's obligations, trade creditors were less willing to continue supplying on credit, and MFP had difficulty raising fresh cash.
On September 1, 2016, the first $1 million installment owed to CPI came due and CPI, deeming itself insecure, also demanded payment of the remaining $1 million balance of the loan that would otherwise have been due September 1, 2017. The CPI loan was one of the few obligations upon which MFP had been careful to remain current. In fact, MFP had made each regular interest payments to CPI on the 15th day of each month as required by the loan agreement. When it received the CPI demand for full payment of principal, MFP asked for some time to get some money together. CPI gave MFP two additional weeks and on September 15, 2016, MFP paid CPI the entire $2 million principal.

The $2 million payment constituted a further drain on MFP's resources and its financial difficulties increased thereafter. In an attempt to preserve cash, MFP failed to remit to the Internal Revenue Service its October payment of employment taxes and taxes withheld from its employees' wages and instead used the money to meet demands from trade creditors. MFP timely paid its employment taxes and wage withholding for November and December 2016. On December 30, 2016, recognizing that MFP's principals might be liable for penalties for MFP's failure to remit the wage withholdings held in trust for employee taxes, MFP paid the IRS the funds it had withheld from its employees’ wages in October. At the same time, MFP paid the employment taxes that had been due in October.

On January 2, 2017, MFP filed a Chapter 11 petition. In its schedules, it listed debts totaling $10 million and assets of $4 million, which consisted primarily of inventory and equipment.

The following specific issues have arisen in the MFP bankruptcy. Please analyze each of the issues in light of the facts and suggest both legal and strategic approaches to each issue.

1. FirstBank has asserted a secured claim in MFP's bankruptcy proceeding. MFP, as debtor in possession, would like to invalidate FirstBank's security interest and also to recover the October 2016 interest payment made by MFP to FirstBank. Discuss the legal theories that can be asserted by MFP, any defenses available to FirstBank, and decide who would likely win. If MFP decides to pursue its action against FirstBank, how should it do so procedurally?

2. Discuss whether legal grounds exist for requiring CPI to disgorge any of the interest payments made in 2016 or the $2 million repayment of principal that was made on September 15, 2016. Discuss also the arguments available to CPI in a suit to recover any of MFP's payments. If you determine that MFP would have a strong case for recovery from CPI, discuss whether you would advise MFP to pursue the action. If MFP did not pursue the action, discuss what advice you might give to a creditor's committee with respect to an action against CPI.

3. Discuss whether MFP can recover any of the December 2016 payments that it made to the IRS.

4. When Mead, the president of MFP, purchased his new house in February of 2016, he obtained a $1.5 million mortgage loan from County Bank. MFP guaranteed Mead's obligation under the mortgage loan. Mead has defaulted on his obligation to County Bank, the bottom has fallen out of the real estate market so that the fair market value of the house is now less than $1 million, and County Bank has filed a claim in the MFP bankruptcy, seeking to enforce the guaranty. Discuss whether MFP, as debtor in possession, can successfully object to County Bank's claim and analyze the theories that MFP would use and any defenses available to County Bank.

5. On January 3, 2017, in response to MFP's bankruptcy filing, FirstBank froze MFP's bank account, which had a balance of $200,000. FirstBank has filed a motion seeking permission to set off the balance of the account against its $5 million claim, or, in the alternative, seeking a court order confirming that it has a
$200,000 secured claim and conditioning MFP's use of the funds in the account on its provision of adequate protection of the bank's interest in the funds. MFP has responded by asserting that the balance in the account increased from $25,000 ninety days before bankruptcy to $200,000 on the date of the commencement of the case and has argued that the bank's interest in the account should be limited to the balance 90 days before bankruptcy. Discuss (a) whether the bank violated the automatic stay by freezing the account; (b) whether the bank's right of setoff is limited to $25,000 or is available for the entire account balance; (c) whether the bank has a secured claim with respect to the funds in the account; and (d) whether the bank is entitled to adequate protection prior to the debtor's use of the funds in the account.

6. Tacoma Paper Supply delivered $20,000 of paper to MFP on December 29, 2016 on unsecured, 30-day payment terms. On January 3, as soon as it learned of MFP's bankruptcy filing, it sent a letter to MFP demanding return of its paper. Discuss whether Tacoma Paper will be able to recover its paper or, if not, whether it will be entitled to any other remedy. Consider whether FirstBank's security interest will have any effect on your analysis.

7. Several employees have filed secured claims against MFP for wages accrued but not paid during December, 2016. They base their claim for security on a state statute that gives employees of a business a senior lien on all assets of an insolvent business to secure unpaid wages. Under the applicable statute, the lien is available only if the business is insolvent. MFP has objected to the employees' secured claim. Discuss whether MFP's objection is likely to be successful and whether the employees might have any other basis for demanding better treatment than other creditors.

**ANSWER**

1. The debtor in possession has the rights of a bankruptcy trustee. The DIP can use the preference avoidance power to avoid FirstBank's security interest. Although the security interest was granted to FirstBank long before the preference period, section 547(e) provides that the "transfer", for purposes of section 547, occurred when the security interest was perfected November 18, 2016. Therefore, the transfer was within the 90-day look back period and is likely avoidable as a preference under section 547. The transfer of the security interest was for the benefit of the creditor (FirstBank), was on account of an antecedent debt, during a time when the debtor is presumed to have been insolvent pursuant to section 547(f). If FirstBank is allowed to assert the secured claim, it would receive more than it would have received in Chapter 7 liquidation without the transfer. Therefore, the security interest is avoidable.

Avoiding the October 7, 2016, interest payment will be more difficult. As a regular installment payment on a long-term debt, the payment may be considered as having been made in the ordinary course of business. Union Bank v. Wolas, 502 U.S. 151 (1991) (payments on long-term debt, as well as payments on short-term debt, may qualify for the ordinary course of business exception). The loan was obtained in the ordinary course of MFP's business (to provide working capital) and the payment was made consistent with the ordinary course of business as historically conducted by MFP and FirstBank. FirstBank could also support an ordinary course defense if it is able to prove that the loan and payments were made consistent with the ordinary business practices of the printing and lending industries. Another defense that could be raised is that because the interest payments were only owed as they came due, they do constitute payments on account of a pre-existing debt. This is a minority position and is further weakened by the week late payment of an installment that appears to have been due on September 30, 2016.

As to procedure, for the debtor to avoid the security interest claimed by First Bank, it would need
to initiate an adversary proceeding. Bankruptcy Rule 7001(2) (adversary proceeding required to
determine validity of lien). Merely seeking denial of the bank’s secured claim by way of objection would
be less certain to eliminate the lien.

2. Because the interest and principal payments all occurred by September 15, 2016, they were
made outside the normal 90-day preference period and can only be avoided if determined to be within
the one-year avoidance period provided by section 547(b)(4)(A) for transfers to insiders. However, no
recovery would be possible against CFI under section 547(i), which limits the source of recovery for an
avoidable transfer made between 90 days and one year prior to the filing to the benefited insiders.
The recipient of the funds, CPI, may not be sued to recover the funds.

The DIP may still make a strong case to avoid the transfers (as to the insiders) because the payments
of principal and interest were for the benefit of the insiders who had guaranteed the CFI loan, Levit
v. Ingersoll Rand Financial Corp. (In re Deprizio Construction Co.), 874 F.2d 1186 (7th Cir. 1989). MFP’s
payment of the principal and interest benefitted the insiders by relieving them of their obligations on the
guarantees. Because the payments benefitted insiders, they constituted insider preferences. As insider
preferences, these payments are subject to the one-year insider preference period rather than the normal
90-day period.

The insiders would likely argue that the payments were in the ordinary course of business and are
excepted from preference attack. The interest was regularly paid on a timely basis and could easily be fit
within the ordinary course of business. Under Union Bank v. Wolas, the payment of the first $1 million
in principal might be considered ordinary course since the payment was due on September 1, 2016 and
paid in a reasonably timely fashion. It would be difficult to maintain that the second $1 million in
principal was an ordinary course payment. In re Schick, 234 B.R. 337 (Bankr. S.D.N.Y. 1999) (debtor’s
early repayment of obligation to creditor, because creditor deemed himself insecure, was not in the
ordinary course of business).

Even with respect to the interest and the first million-dollar payment, MFP will argue that the
payments were not in the ordinary course of business and did not fit within the ordinary course exception
to preference avoidance. The payments clearly benefitted insiders and would likely have been made even
if there was not enough money to pay other obligations. Particularly with respect to the $1 million
principal repayment, it seems unlikely that a debtor in financial difficulty would pay a substantial
obligation without any attempt to renegotiate the terms of the transaction. MFP might also argue that
the two-week delay in paying the $1 million due on September 1, 2016, takes the payment out of the
ordinary course.

An attorney for MFP would be in a conflicted position with respect to this preference. The only
source of recovery is the insider guarantors, who are the officers and directors of the DIP. They are
unlikely to want to pursue the alleged preference. Yet the debtor may owe a fiduciary duty to the other
creditors to actively pursue the preference. The attorney should remember that he or she is a
representative of the estate, not the principals.

If the debtor did not pursue the action, the creditor's committee might seek authority to pursue
the action on behalf of the debtor. Although the creditor's committee could seek a court order directing
the DIP to pursue the action, the debtor might not energetically prosecute an action that is unfavorable to
its officers and directors. Therefore, the creditor's committee should seek authority to pursue the action
itself, on behalf of the debtor.
3. Payment of the trust fund taxes is probably not recoverable because the money withheld from employees' wages would not be considered property of the estate. Begier v. I.R.S., 496 U.S. 53 (1990). Payment of the employment taxes probably would be recoverable as a preference. In re Pullman Const. Industries, Inc., 190 B.R. 618 (Bankr, N.D., Ill, 1996) (late payment of tax debt not in ordinary course of business). However, the avoidance action could fail if the debtor was unable to determine that the IRS received more than it would have in a Chapter 7 liquidation due to tax debt enjoying priority status under section 507. Sovereign immunity would not be an available defense for the IRS. Section 106(a) and Central Virginia Community College v. Katz, 547 U.S. 356 (2011).

4. MFP would argue that the guaranty is a fraudulent conveyance avoidable under sections 544(b) and 548. The provision of a guaranty can qualify as a transfer under Section 548. In re American Housing Foundation, 544 F. App'x 516, 519 (5th Cir. 2013). The guaranty was made in February 2016, well within the two-year avoidance period established under Section 548.

MFP strongest argument would be based on Section 548(a)(1)(i) and (iv), which require only a showing that in a transaction within 2 years of the filing date that the debtor made a transfer and received less than a reasonable equivalent value and that the transfer was to or for the benefit of an insider under an employment contract and not in the course of ordinary business. Sub-section (iv), which was added as part of the 2010 bankruptcy code amendments, eliminates any need by the debtor to show that the transfer was made during a time of financial distress. See generally Collier on Bankruptcy (16th Ed.). ¶ 548.05[4].

MFP could also argue that the guaranty is avoidable under the standard analysis of constructive fraud set forth in Section 548(a)(1)(B) by showing that MFP received less than a reasonable equivalent value in return for providing the guaranty and that MFP was either insolvent at the time of the transfer engaging in business with an unreasonably small amount of capital or intended to incur future debts beyond its ability to pay. It seems unlikely that the debtor received reasonably equivalent value in exchange for the obligation it undertook. The entire benefit of the loan seems to have gone to Mead, the insider.

Avoiding the guaranty as an actual fraudulent conveyance under Section 548(a)(1)(A) would be more difficult because it would require the debtor to show actual intent to defraud creditors. However, an obligation undertaken solely for the benefit of an insider is at least suspect and perhaps the burden of proving the lack of intent could be shifted to County Bank. In re Acequia Inc., 34 F.3d 800, 806 (9th Cir. 1994) (once a trustee establishes indicia of fraud in an action under Section 548(a), the burden shifts to the transferee to prove some “legitimate supervening purpose” for the transfers at issue).

County Bank could attempt to demonstrate that the loan guaranty was in the ordinary course of business in order to defeat a claim under Section 548(a)(1)(B)(iv). Such an argument might be persuasive if all executive of specified rand were offered such guaranties as part of their compensation. County Bank could also argue that at the time it was made, the guaranty had a value far less than the total amount of the loan and that MFP received reasonably equivalent value in the form of services performed by Mead. Consideration flowing from a third party, Mead, may be sufficient to enable County Bank to avoid a fraudulent conveyance attack.

5. (a) The automatic stay enjoins any action taken to collect a pre-petition-claim. Arguably the bank's freezing of the account was an action taken to enable the bank to collect its pre-petition claim, but, because the bank also promptly filed a motion seeking permission to set off the balance
of the account against its $5 million claim against estate, freezing the account did not constitute a violation of the automatic stay. Citizens Bank of Maryland v. Strumpf. 516 U.S. 16, 21 (1995). As noted in the Strumpf opinion, a mere freeze does not violate the stay. If the bank cannot freeze the account, it may lose its setoff right as a result of the debtor's withdrawal and dissipation of the funds in the account.

Furthermore, because the funds may be cash collateral, the debtor may not be entitled to use the funds without the bank's consent or the court's permission. If that is so, then the freeze probably does not deprive the debtor of any significant rights with respect to the funds, particularly if the bank timely moves for guidance from the court.

(b) The bank's right of set off is available for the entire balance of the account. If the bank had set off pre-petition, its setoff right would have been limited by the improvement in position test in section 553(b). However, by waiting until after the debtor filed its petition, the bank avoided the operation of section 553(b), which applies only to pre-petition setoffs.

(c) The bank’s right of setoff gives it a secured claim under section 506, which explicitly recognizes setoff rights as one class of secured claims.

(d) The funds in the account are cash collateral. As such, section 363 provides that the debtor may not use the funds unless the bank agrees to the debtor's use or the court approves the debtor's use of the funds. Court approval is conditioned on the debtor's provision of adequate protection to the bank.

6. As subsequently discussed, Tacoma would have a chance to recover the paper delivered four days prior to the bankruptcy filing, but other relief may be easier to obtain and more effective. Under Section 503(b)(9), a vendor may recover the value of any goods provided to the debtor in the 20 days proceeding in the bankruptcy filing by way of an administrative claim.

Tacoma would also have a right to reclaim the paper. Under U.C.C. section 2-702, the unpaid seller has a right to reclaim goods received by a buyer while insolvent if the seller makes a timely demand for reclamation. Bankruptcy Code section 546(c) validates this reclamation right with certain additional requirements. Under section 546(c)(1), the seller must make a written demand for reclamation with 45 days after delivery of the goods or no later than 20 days after the bankruptcy filing date if the 45-day period expires after the filing of the case. The seller seems to have done so in this case. The delivery must have been in the ordinary course of business, which is probably the case with respect to delivery of paper to a printer. The goods must also still be in possession of the debtor, be capable of being identified and the debtor must be insolvent. There is no presumption of insolvency.

The security interest of FirstBank will not be an issue if Tacoma utilizes Section 503(b)(9) but would like be fatal to a claim under Section 546(c). If granted an administrative claim for the value of the goods under 503(b)(9), any security interest attaching to the actual goods will not affect the claim. On the other hand, the right to obtain reclamation under Section 546(c) is specifically subject to the prior rights of a secured party and to similar rights enjoyed by the trustee.

7. The liens claimed by the employees are statutory liens. Because the liens are effective only against insolvent debtors, these liens are avoidable as statutory liens under Bankruptcy Code section 545. Thus, the employees have unsecured claims.
Nevertheless, the employees are entitled to some priority under section 507. Wage claims are entitled to fourth priority up to a maximum of $12,850 per employee for wages earned within 180 days before bankruptcy. Here, the wages were earned within a month before bankruptcy so the employees could receive a fourth priority for up to $12,850 each.
Compu Corp. sells computers via the Home Shopping Network. In August 2014, Compu entered into an agreement with Netware, Inc., whereby Netware would provide free internet service to all customers purchasing a Compu home computer. Under this agreement, Netware was to receive as a royalty two percent of Compu’s gross profits generated from the sale of Compu home computers.

In March 2015, Compu Corp. was experiencing cash flow problems. At that point, it owed Netware $1,200,000 in unpaid royalties. Compu asked Netware if Netware would hold off in trying to collect the unpaid royalties. Netware agreed but asked Compu to sign a no-interest promissory note obligating Compu to pay Netware $1,200,000 in twelve monthly installments of $100,000 beginning in October 2015. Compu executed the note on March 15, 2015.

Over the course of the next six months, Compu customers reported problems with the internet access service provided by Netware. Compu fielded hundreds of these complaints and, in many cases, had to give partial refunds or credits to customers to compensate them for the problems with internet service. In January 2016, officers from Compu and Netware met to discuss the situation. At that point, Compu orally agreed to forego suing Netware for the losses associated with Netware’s defective internet software if Netware would forgive $600,000 of the $900,000 still owing on the March 2015 Note. It is not clear whether Netware is actually liable for the difficulties experienced by Compu’s customers. Netware agreed, and the parties signed the following “Settlement Agreement” on January 13, 2016:

A. Netware has given a loan to Compu of $1,200,000 of which $900,000 remains outstanding.

B. Netware has agreed to deduct $600,000 from the balance leaving an amount due Netware by Compu of $300,000, in exchange for release of all claims against it.

C. Compu agrees to provide a payment to Netware of $50,000 within 7 days of the execution of this Settlement Agreement.

D. The balance of $250,000 shall be paid in 6 equal monthly payments commencing 30 days following Compu’s making the $50,000 payment and continuing each 30-days thereafter for a payment of $50,000 each 30 days.

E. Upon Compu making the final payment to Netware, this loan shall be deemed paid in full and no further compensation shall be due Netware.

F. All monies must be made by check or wire and made directly to Netware and no other parties.

G. Compu hereby releases Netware of all claims of any kind, as of the signing of this agreement.

Compu made each installment due on the remaining $300,000 debt in a timely manner and it was fully paid by the end of June 2016. Netware struggled with numerous business and financial problems throughout the spring and summer of 2016, and on August 15, 2016, it filed a voluntary Chapter 7 petition in bankruptcy. Its end-of-the-year financial statement prepared in early January 2016 showed that it had approximately $1.5 million in assets and $2.1 million in liabilities as of December 31, 2015.
The trustee appointed in Netware’s bankruptcy is examining the transactions between Netware and Compu. On what basis might it attack those transactions under the Bankruptcy Code? Can Compu offer any defenses? Discuss fully.

**ANSWER**

This question deals primarily with “constructive fraud” fraudulent transfers, subject to avoidance under § 548(a)(1)(B). Testers might also note that 1) because the transfer occurred more than 90 days prior to the filing date and did not involve a transfer to an insider, the transfer is not avoidable as a preferential transfer under § 547; 2) because the transfer took place within two years of the filing date, there is no need for the trustee to rely on his strong arm powers under § 544 to bring a state law claim under the UFTA’s four year reach back period; and 3) because the question includes no evidence of the intent to defraud creditors § 548(a)(1)(A) is not applicable.

The trustee in bankruptcy (“the Trustee”) will argue that Netware’s (“the Debtor”) reduction of the balance owed it by Compu under the March 2015 promissory note (“the Note”) was a constructively fraudulent conveyance pursuant to § 548(a)(1)(B).

The cause of action under § 548(a)(1)(B) is often referred to as "constructive fraud" because it omits any element of intent. In order for a trustee to establish a fraudulent conveyance under § 548(a)(1)(B), he/she must prove the following elements: (1) a transfer of the debtor's property or interest therein; (2) made within two years of the filing of the bankruptcy petition; (3) for which the debtor received less than a reasonably equivalent value in exchange for the transfer; and (4) either (a) the debtor was insolvent when the transfer was made or was rendered insolvent thereby; or (b) the debtor was engaged or about to become engaged in a business or a transaction for which its remaining property represented an unreasonably small capital; or (c) the debtor intended to incur debts beyond its ability to repay them as they matured. *Dunham v. Kisak*, 192 F.3d 1104, 1109 (7th Cir. 1999). The Trustee must prove each element by a preponderance of the evidence. *Friedich v. Mottaz*, 294 F.3d 864, 867 (7th Cir. 2002).

When a transfer is avoided under § 548(a), one then needs to look to 11 U.S.C. § 550(a), which provides that "the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property. . . ." 11 U.S.C. § 550(a)(1). Once the whole transfer has been pulled into the estate, the money is distributed according to the priorities established by the Code and the debtor's own commitments.

The examinee should address each element the Trustee must establish under §548(a)(1)(B) in turn.

A. Whether there was a transfer

The initial issue to be determined is whether the Debtor's reduction of the $600,000 balance due on the Note was a "transfer" of an interest of the Debtor in property for purposes of § 548(a)(1)(B). The Bankruptcy Code defines "transfer" to include "every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property. . . ." 11 U.S.C. § 101(54). The legislative history indicates that this definition is meant to be broad. S.REP. No. 95-989, at 27 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5813. Generally, the hallmark of a “transfer” is a change in the rights of the transferor with respect to the property after the transaction. While the Bankruptcy Code does not define "an interest of the debtor in property," courts
have held that "property belongs to the debtor . . . if its transfer will deprive the bankruptcy estate of something which could otherwise be used to satisfy the claims of creditors." *In re Merchants Grain by & Through Mahern*, 93 F.3d 1347, 1352 (7th Cir. 1996) (internal quotation omitted).

Therefore, the $600,000 reduction of the balance due under the Note constitutes a transfer of an interest of the Debtor in property under the definitions set forth above. By entering into the Settlement Agreement with Compu, the Debtor parted with $600,000 that it was otherwise entitled to receive under the terms of the Note given it by Compu. The Debtor could have used this money to satisfy the claims of its creditors. Thus, the Debtor's forgiveness of a portion of the debt owed it by Compu constitutes a "transfer" for purposes of § 548(a)(1).

B. Whether the transfer occurred within two years of the filing of the case

Next, the $600,000 reduction of the balance due on the Note occurred within two years of the filing of the Chapter 7 case. The Settlement Agreement, which embodied the reduction of the debt owed by Compu to the Debtor, was entered into on January 13, 2015, and the Debtor filed the Chapter 7 case on August 15, 2016. Hence, this element has been met.

C. Whether there was reasonably equivalent value given in exchange for the transfer

Compu will argue that it was its intention to treat the $600,000 reduction of its indebtedness to the debtor under the Settlement Agreement as the recovery of a portion of any actual or potential future losses caused by the Debtor through its right of setoff, and that the Debtor would have a credit in that amount against any judgment ultimately entered or claim allowed in favor of Compu against the Debtor. Thus, the reduction of its indebtedness to the Debtor under the Settlement Agreement was sufficiently satisfactory to Compu that it did not commence legal action against the Debtor. Compu will contend that had the parties not entered into the Settlement Agreement, it would have sued the Debtor for damages caused by the Debtor's failure to provide free internet service as promised to Compu and its customers. Moreover, Compu will assert that the Settlement Agreement constituted a settlement of $900,000 of the outstanding Note for the sum of $300,000 free and clear of Compu's rights of setoff. Compu will claim that by agreeing to the payment schedule in the Settlement Agreement, it saved the Debtor from incurring costs to pursue its remedies related to repayment of an amount that was both uncertain and subject to defenses. Thus, according to Compu, the reduced payment schedule in the Settlement Agreement provided value to the Debtor.

The Bankruptcy Code does not define the term "reasonably equivalent value." However, courts have suggested that the test utilized to determine "reasonably equivalent value" requires the court to determine the value of what was transferred and compare that value to the value the debtor received. *Barber v. Golden Seed Co.*, 129 F.3d 382, 387 (7th Cir. 1997). The determination of "reasonably equivalent value" is not a fixed mathematical formula. *Id.* Section 548(d)(2)(A) of the Code defines "value" as "property, or satisfaction or securing of a present or antecedent debt of the debtor. . . ." 11 U.S.C. § 548(d)(2)(A).

Usually, the determination of "reasonably equivalent value" under §548(a)(1)(B) is a two-step process, *Anand v. Nat'l Republic Bank of Chi.*, 239 B.R. 511, 516-17 (N.D. Ill. 1999). The court must first determine whether the debtor received value, and then examine whether the value is reasonably equivalent to what the debtor gave up. *Id.* at 517. The second inquiry, whether what the debtor gave up was reasonably equivalent to what he received, is more difficult. *Id.* Equivalent value must be measured
as of the time of the transfer.

Whether "reasonably equivalent value" has been given is a question of fact that depends on the circumstances surrounding the transaction. Barber, 129 F.3d at 387. The factors utilized to determine reasonably equivalent value are: (1) whether the value of what was transferred is equal to the value of what was received; (2) the market value of what was transferred and received; (3) whether the transaction took place at arm's length; and (4) the good faith of the transferee. Id.; Grigsby v. Carmell (In re Apex Auto. Warehouse, L.P.), 238 B.R. 758, 773 (Bankr. N.D. Ill. 1999). The Trustee bears the burden of proof on this issue. See Barber, 129 F.3d at 387.

The examinee should discuss whether the Debtor received consideration from Compu under the terms of the Settlement Agreement that had a value that was reasonably equivalent to the $600,000 reduction of the indebtedness. Apparently, the Settlement Agreement did not contain any language that set forth the causes of action Compu may have had against the Debtor.

The resolution of this question may rest on whether Compu can produce any evidence to demonstrate or corroborate that it suffered, at a minimum, damages in the amount of $600,000. If Compu can demonstrate such damages, it can then rely on Provision G of the Settlement Agreement, in which Compu released the Debtor from all claims of any kind. The compromise of a dispute has been recognized as a form of contractual claims consideration. Schaps. v. Just Enough Corp, (In re: Pinto Trucking Service, Inc.). 93 B.R. 379 (Bankr. E.D. Pa. 1988).

D. Whether the Debtor was insolvent

Finally, the Trustee must prove that the Debtor was insolvent within the meaning of the Bankruptcy Code when it made the fraudulent conveyance. There is no rebuttable presumption of insolvency, as is the case for actions seeking to avoid preferential payments under § 547. Section 101(32) of the Code employs a balance sheet approach to the question of insolvency. Steege v. Affiliated Bank/N. Shore Nat'l (In re Alper- Richman Furs, Ltd.), 147 B.R. 140, 154 (Bankr. N.D. Ill. 1992).

A trustee may utilize appropriate means to prove insolvency, including balance sheets, financial statements, appraisals, expert reports, and other affirmative evidence. Freeland v. Enodis Corp. (In re Consol. Indus. Corp), 292 B.R. 354, 360 (N.D. Ind. 2002). Netware’s financial statement at the end of 2010 reveals that its liabilities exceeded its assets, and hence, the Debtor was probably insolvent on January 13, 2016, when it executed the Settlement Agreement with Compu.

In conclusion, if the bankruptcy court finds that the Trustee has met all of the elements to establish that the transfer was constructively fraudulent under § 548(a)(1)(B), then under § 550(a)(1), the Trustee may recover the $600,000 transfer from Compu for the benefit of the Debtor's estate unless Compu can offer a viable defense.

E. Whether Compu has a defense under §548 (c)

Section 548(c) of the Bankruptcy Code provides that a transferee “that takes for value and in good faith has a lien on or may retain any interest transferred . . . to the extent that such transferee or obligee gave value to the debtor in exchange of such transfer or obligation.” Thus, even if Compu did not give reasonable equivalent value for the transfer it received, it can reduce the amount of the fraudulent conveyance by the amount of value that it did give in good faith.
If the bankruptcy court finds that Compu gave no value at all because the litigation was meritless or worth much less to Compu, then Compu will not prevail on this defense. Compu can probably succeed in arguing that it acted in good faith. There is no indication that Compu entered into the Settlement Agreement in an attempt to defraud the Debtor’s creditors.
Business Subspecialty Essay

Question C

(Suggested Time - 1 1/2 hours)

Danny Smith ("Danny") has sought advice regarding a potential business filing. He and his brother and sister each own 25% of the stock in Romantic Isle, Inc., a 30-acre amusement park in San Bernardino County, California.

Romantic Isle, Inc. was founded by Danny’s parents, John and Mary Smith. Between 1985 and 2012, John and Mary loaned Romantic Isle approximately $10,000,000 in order to sustain park operations. And while park operations never generated a significant profit (and, in many years, generated no profit), Romantic Isle made significant profits from sales of the surrounding land.

In January 2015 John suffered a serious heart attack, and their financial advisors persuaded them to develop and implement an estate plan. As part of that plan, in March 2015, John and Mary transferred 75% of the ownership in Romantic Isle to Danny and his siblings, and the remaining 25% to the Smith Family Trust ("Trust"). In addition, the debts owed by Romantic Isle to John and Mary were assigned to the Trust and documented by a promissory note executed in favor of the Trust for $10,000,000 (the "Note"). The Note called for annual “interest only” payments (at a rate of 8% per annum), with the balance due in the form of a balloon payment on March 15, 2025. The Note was secured by a first deed of trust on the 30-acre park property and the surrounding acreage not yet sold (15 acres).

Immediately after the transfers and assignment described above, John resigned his position as president of Romantic Isle, but remained Chairman of the Board of Directors. Danny assumed the position of President and took control of park operations. Although John was unable to perform his normal duties and responsibilities as President, he continued to receive compensation payments of $20,000 per month from Romantic Isle pursuant to an employment contract dated April 1, 2015.

It was not long after Danny took over Romantic Isle that he saw the park was losing money. In order to turn the park into a money-making enterprise, Danny attempted a number of business strategies, including leasing new carnival rides, constructing new facilities, and hiring a marketing firm. To fund these efforts, as well as his annual salary of $350,000, Danny negotiated sales of the remaining 15 acres surrounding the park. Danny also arranged a $500,000 line of credit from Bank of Barstow, secured by a “blanket lien” on all assets.

Unfortunately, notwithstanding Danny's efforts park operations did not generate significant profits. Romantic Isle is two years behind on interest payments to the Trust, and approximately 60 days past due on payments to Bank of Barstow, equipment lessors, and vendors. Payroll and payroll taxes are current.

Danny has been approached by a land developer from Los Angeles, Abe Allgood, who has advised Danny that, by closing the park and developing the property as a mixed-use project, including high rise residential condominiums, he could generate profits in excess of $50 million. Abe’s proposal calls for a transfer of a 1/3 interest in Romantic Isle to him, in exchange for arranging financing, and providing development services, with
Hearing of Danny's plan, however, John Smith became enraged. He has engaged counsel, commenced foreclosure on the real property, and demanded that Danny refund what John asserts is an excessive salary.

On March 1, 2018, Danny came to you in his capacity as President of Romantic Isle, seeking advice about the costs and benefits of filing bankruptcy. You have discussed issues relating to the challenges posed by the Trust obligations, and the potential of Abe's development plan. Following these discussions, Danny and his siblings decided that Romantic Isle should proceed with filing a Chapter 11 and you do so on April 1, 2018.

The company’s assets and liabilities are summarized as follows:

### Assets/Values:

- **Real Property** currently used for operation of the amusement park: $15,000,000 or $50,000,000 (depending on whether sold or redeveloped)
- **Raw land value** estimated at $15,000,000 if sold for development; but Danny estimates potential profit if developed through joint venture to be $50,000,000.

<table>
<thead>
<tr>
<th>Asset</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash on hand</td>
<td>$180,000</td>
</tr>
<tr>
<td>Leased Equipment (FMV)</td>
<td>$55,000</td>
</tr>
<tr>
<td>Personal property (FMV)</td>
<td>$15,000</td>
</tr>
</tbody>
</table>

### Liabilities:

- **Trust note**: $11,600,000
  - ($10,000,000 principle, plus interest of $1,600,000 past due)
  - (Secured by 1st Trust Deed on Real Property):
- **Bank of Barstow note**: $510,000
  - ($500,000 principle, plus interest of $10,000 past due)
  - (Secured by 2nd Trust Deed on Real Property)
- **Real Property Taxes**: $20,000
- **Equipment lessors (rides)**: $100,000
  - (monthly payments of $50,000, two months past due)
- **Trade debt**: $35,000

Please answer the following questions:
1. Is Romantic Isle, Inc. a "Small Business Debtor" under the Bankruptcy Code, and if so, what must it do in its chapter 11 case?

2. What must Romantic Isle do in order to keep all of its leased equipment?

3. Does John Smith have any problems under the Bankruptcy Code relating to any payments made to him by Romantic Isle?

ANSWER

1. Romantic Isle is most likely a “Small Business Debtor” as defined by §101(51D). Its debts do not exceed $2,566,050 excluding debts owed to one or more affiliates. The $11,600,000 debt owed to the Trust is a debt to an affiliate because the Trust owns a 25 percent interest in Romantic Isle. An affiliate is defined to include an entity which controls 20 percent or more of the debtors’ outstanding securities, §101(2)(A). Because Romantic Isle is a Small Business Debtor, its Chapter 11 filing will be treated as a “Small Business Case,” § 101(51C).

   Test taker should discuss obligations under such sections as Sections 1116, Section 308(b), Section 1121(e), Section 1125(f), and Section 1129(e).

2. In order to keep all of the lease equipment in the early stages of the case, the Debtor must timely perform all of its obligations under a personal property lease first arising 60 days after the entry of the order for relief, which occurs upon filing for a Chapter 11 case. U.S.C. Sec.365 (d)(5). The Debtor is excused from having to fulfill such obligations as specified in section 365(b)(2), that relate to the lessee’s financial condition. Simply put, the Debtor must start paying the rent within 60 days.

   The Debtor may delay deciding whether to assume or reject the leases until the time of confirmation. §365(d)(2). However, if the Debtor ultimately wants to assume the leases, it must cure any pre- or post-filing default. §365(b). In the present case, $100,000 in pre-petition defaults would have to be cured, plus any post-petition defaults, in order to assume the equipment leases.

3. John Smith is an "insider" as that term is defined pursuant to 11 U.S.C. Sec. 101(31)(B)(i). John received $20,000 per month for the two-year period preceding the petition date. Due to his health condition he was unable to perform any services for his monthly compensation. All payments made to John within two years before the petition date may be avoidable fraudulent transfers under Sec. 548(a)(1).