

CAPITAL UNIVERSITY LAW SCHOOL -- SPRING 1994
PROFESSOR FERRIELL -- DEBTOR-CREDITOR RELATIONS
FINAL EXAM

Instructions

Failure to follow these instruction will lead me to question your ability to read, understand, and apply legal rules and thus may adversely affect your grade.

1. This is a three (3) hour examination consisting of three essay questions. The first question is worth 34 possible points. The second question is worth 33 possible points. The third question is worth 33 points. Divide your time accordingly.
2. This exam will be counted as 100% of your grade for the course.
3. You may have with you during the exam your copy of the assigned course materials. These include Warren & Westbrook, Blum, the Bankruptcy Code, and any notes or outlines prepared by you personally or a study group consisting of Capital students enrolled in any Spring 1994 semester section of this course, of which you are a member. You may not have other materials although you may use a calculator if you wish.
4. Limit your answers to the page limits indicated with each question: A "page" according to Webster, is "one side of a leaf in a book." Leave the customary margins at the top and left side and do not write more lines than the number of lines printed on the page. I will not read and you will not receive credit for anything written beyond these limits.
5. You may leave the room during the exam if you need to because of illness (including nicotine addiction) or incipient incontinence.
6. I will not answer any questions about the exam after it begins but will make reasonable efforts to calm you down and get you back to work if you find, for one reason or another, that you are having difficulty completing the examination.
7. In making any financial calculations required you should assume that the prevailing rate of interest is 8% and that this rate of interest will require monthly payments of the following amounts to fully pay each \$1,000 of debt at that rate over the following periods:

Payments per \$1,000 for 1 Year: \$85

Payments per \$1,000 for 2 Years: \$45

Payments per \$1,000 for 3 Years: \$30

Payments per \$1,000 for 4 Years: \$25

Payments per \$1,000 for 5 Years: \$20

For example, if a debt of \$2,000 will be paid over 2 years you can determine that the necessary monthly payment will be \$90. The monthly payment necessary to pay a \$1,000 debt over 2 years is \$45. Since this debt is \$2,000 you can simply multiply the \$45 figure times 2 (2 x \$1,000).

If a debt of \$7,000 must be paid over 4 years, -multiply \$25 (the mo. payment per each 1000) x 7 because you have 7 thousand dollars in debt) to reach the conclusion that \$175 would be the monthly payment necessary to satisfy a \$7,000 debt over 4 years at the prevailing rate of 8% interest.

To determine how much would be necessary to amortize a \$300 debt over 2 years use the figure for \$1000 (\$45) times 0.30 (300 is .3 of 1000), to reach a monthly payment of \$13.50.

8. Good Luck.

QUESTION I - 34 POINTS

LIMIT YOUR ANSWER TO 3 PAGES IN A BLUEBOOK

I encourage you to spend no more than 1 hour on this question.

A law clerk working in your office has prepared a chapter 13 plan for your clients Linda and Larry Leisure.

Larry and Linda own a house which is worth approximately 70,000 and which is subject to a perfected purchase money mortgage in favor of Home State Bank. The mortgage, perfected at the time the Leisure's purchased their home for \$60,000, 8 1/2 years ago, secures an outstanding remaining principal debt of \$49,500. Interest on this debt is approximately \$350 per month, with \$65 of their \$415 monthly payment going to principal. Selling the house for its fair market value would cost approximately \$5,000 in fees, expenses, and commissions. Larry and Linda have missed this month's payment, thus increasing the amount of their total obligation to Home State Bank, including late fees, to \$50,000.

Under Ohio's exemption statute a person is entitled to \$5,000 exemption in that person's interest in any residential real estate.

Larry and Linda also lease a 1994 Ford Windstar Minivan, worth \$18,000, with monthly rental payments of \$250 for the next 4 years and 8 months. They missed last month's rental payment and are unable to make additional payments unless their financial circumstances change.

Larry and Linda also own a variety of personal property all of which is exempt under Ohio's exemption statute.

In addition to their home mortgage and auto payments, Larry and Linda owe the following obligations:

\$300 on their 1990 income taxes. Larry and Linda have been making payments to the IRS for their 1990 taxes since May, 1991 when the IRS assessed a deficiency against them after an audit. At that time, they entered into an agreement to pay the IRS \$20 per month and have whittled their \$1000 tax liability down to the \$300 remaining due.

Larry and Linda also owe \$1100 on large screen TV they purchased a year ago for \$1500, from Home Appliance Ware-house. Their \$50 per month payments over the past year have reduced the principal debt, secured by a perfected purchase money security interest, to the \$1100 still owing. They tried to sell the TV a few months ago but, after placing an ad in the paper and attempting to sell it to a used TV dealer, the highest offer they were able to obtain was for \$700. Rather than selling the TV and continuing to make payments for a TV they didn't own, they decided to keep it.

Linda owes \$10,000 in medical bills she incurred after a recent serious illness. Although she is recovering, she is will be unable to return to work for 6 months.

Linda and Larry owe \$5,000 in VISA credit card charges for cash advances obtained during Linda's illness to pay certain other medical expenses and to meet their living expenses over the past three weeks. Yesterday, they obtained another \$1000, on a MASTERCARD account to obtain cash to pay their legal fees connected to the bankruptcy and also to pay the filing fee in their chapter 13 case to be filed in a few days.

Larry may be liable for as much as \$90,000 to Polly Pedal, whom Larry ran into while riding his own bicycle after drinking several beers at the end of the annual Mother's Day Bicycle Ride to Riverview, 100 miles from Larry and Linda's home. Polly was seriously injured in the accident which she attributes to Larry's drinking. Under relevant state law, a bicycle rider has the same legal responsibilities as the driver of an automobile. Although Polly has sued for as \$90,000, the firm believes that she will probably be willing to settle for \$75,000.

Larry's job pays \$1400, after taxes. When she was working Linda earned \$800 per month after taxes.

Their monthly living expenses, when they can afford to meet them total \$1400, as follows:

- \$415 per month mortgage payment (described above)
- \$20 per month to the IRS (is described above)
- \$250 per month in car payments (as described above)
- \$50 per month on the TV (ad described above)
- \$275 per month for groceries
- \$30 per month for clothing
- \$50 per month for electric service.
- \$50 per month for natural gas
- \$35 per month for cable TV
- \$30 per month for telephone

\$50 per month for Computer Bulletin Board Services
\$100 per month for auto insurance (recently canceled, however)
\$50 per month for home owners insurance

This, unfortunately leaves them with no money to satisfy Linda's medical bills or to compensate Polly for her injuries. One of Linda's medical creditors has obtained a judgment and Larry, who agreed to pay her medical bills, is about to have 25% of his net earnings garnished.

The strategy outlined by your law provides for the following treatment of your client's creditors:

Direct payment of the \$415 monthly mortgage obligation to Home State Bank.
Direct payment of the \$250 monthly lease payments on the Windstar.

The payment of \$150 per month to the trustee for distribution in the plan over the next 3 years, to be distributed as follows:

\$10 per month to the trustee for her fees in the case.

\$140 per month for the first 8 months in full payment, at 8% interest of the \$1100 debt owing to TV World in connection with the Large Screen TV.

\$140 per month for the remaining 2 years and 4 months to be paid, on a pro-rata basis to Polly, the Medical Bills, and on their Credit Cards, and the IRS, resulting in a total of \$3920 in total payments to these creditors resulting in a 3.5% dividend for their unsecured claims.

Draft a memo analyzing whether their chapter 13 plan is likely to be confirmed despite possible objections from interested parties. In your memo, indicate what specific changes might be made to correct any defects in the plan without creating other successful grounds to object. Be sure to state and plausibly support all financial assumptions upon which you base your analysis.

QUESTION II- 33 POSSIBLE POINTS
LIMIT YOUR ANSWER TO 3 PAGES IN A BLUEBOOK

Outdoor Activities Inc. (OAI) filed for relief under chapter 11 on May 1, 1994. It anticipates proposing a plan calling for payments of \$1,000,000 to its unsecured creditors, with interest. At the time of its petition, OAI held unencumbered assets of \$400,000, all of which would have been used to satisfy the claims of unsecured creditors.

In the several years prior to its petition, OAI engaged in the following transactions:

On June 30, 1993 OAI paid \$100,000 to First Federal Bank, in satisfaction of an operating loan made six months earlier to enable OAI to meet its payroll when one of OAI's largest

customers failed to make timely payment of its account. The loan was guaranteed by Bella Beltway, owner of 60% of the stock of OAI.

On March 1, 1993, (more than 1 year before bankruptcy) Equipment Lender's Inc. repossessed some of OAI's valuable equipment and, at a public auction held in compliance with state law, sold it for \$50,000, the amount of the outstanding indebtedness to Equipment Lenders, even though the equipment was probably then worth \$75,000.

On February, 1, 1994, in an effort to solve some of its financial difficulties, OAI entered into a contract to sell a parcel of real estate it joined to a land developer for a price of \$200,000. Under the terms of the contract, which was never recorded, the developer was required to make regular monthly interest payments to OAI for 2 years. At that time the developer was required to pay OAI the entire \$200,000 and OAI would convey a deed to the developer. Immediately after entering into the contract the developer entered the premises and began making substantial improvements. The developer's plans to improve the property and sell it for an amount sufficient to pay OAI the \$200,000 seems promising. The developer has already spent \$150,000 on improvements. Further, the market value of the real estate, even without developer's improvements has risen to \$250,000 since the contract was entered into.

On February 10, 1994 OAI finally lost an important court battle it had been engaged in with "Mountain" Mike Madden, who was seriously injured during one of OAI's mountain expeditions. Mike won a judgment for \$200,000 and on February 21, 1994 filed a copy of that judgment in the county in which OAI's office building, also owned by OAI, was located. The office building is worth \$500,000, but is subject to an outstanding purchase money mortgage of \$300,000. The mortgage was recorded at the time the building was purchased.

QUESTION III - 33 POINTS
LIMIT YOUR ANSWER TO 3 PAGES IN A BLUEBOOK

I strongly encourage you to spend no more than 1 hour on this question.

Accrual Corp. entered into an agreement with Business Machines R Us for the acquisition and use of a computer network. Under the terms of the agreement, Accrual Corp. agreed to take possession of the computer. Business Machines R Us acquired the machine from its manufacturer for the purpose of the transaction with Accrual Corp.

The agreement entered into between the parties provided for payment of \$2000 per month for a 5 year period as rent for the system. This amount is identical to the amount necessary to pay a \$100,000 debt at 8% interest, over a 5 year period. Furthermore, computer networks like the one involved cost \$100,000 two years ago when the agreement was entered into. The rent remaining due is approximately \$72,000 (\$2000 x 36 months). Unfortunately, because of improvements in competitor network technology, and increased supply, the system is worth no more than \$50,000 today. Further, because of its diminished business during the reorganization process, Accrual is only using approximately 75% of the capacity of the network. Needless to say,

Accrual has stopped making any payments to Business Machines R Us since it filed its chapter 11 petition a month and a half ago.

Accrual Corp. has consulted you regarding its continued use of the system, which, although worth only \$50,000, would be costly to replace. Draft a concise memo focusing on two questions:

1) Will Accrual be able to continue using the computer network pending promulgation of its plan of reorganization, and if so, what obligations will Accrual have to Business Machines R Us during that period.

2) What obligations will Accrual be required to incur in its plan if it wishes to retain the computer network after its reorganization plan is approved by the court?

You may assume that Business Machines R Us will seek to fully enforce all of its rights to the return of the computer network system, or payment of all amounts the bankruptcy court would require Accrual to make as a condition of its continued use of the system.