Seven or Eleven

Consequences of Chapter 7

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- The Internal Revenue Service would, by law, come to the front of the line and take its $10,000.
- The 87th National Bank would then get its $50,000, and the rest would be split up amongst the other creditors, depending on something called their priority.

Priority

- Two cases to be considered:
  – Acme Venture Capital owns preferred stock. Then it is junior capital, and the $50,000 is split among the other creditors. Johnny and Acme Venture Capital get nothing.

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  – Acme Venture Capital owns preferred stock. Then it is junior capital, and the $50,000 is split among the other creditors. Johnny and Acme Venture Capital get nothing.
  – Acme Venture Capital has a second mortgage on the building and the business. Then it gets the remaining $50,000. Johnny and the other creditors get nothing.

The Lease

- Johnny's Restaurant would clearly do is to cancel the lease on the adjoining building.
- When it does so, it converts Draper and Kramer into another unsecured creditor.

The Lease

- For example, suppose the lease provided that Draper and Kramer are paid $10,000 a year for the next 5 years, and that the alternative is to lease the property for $5,000 per year.
- Draper and Kramer is an unsecured creditor, for it has been damaged by $25,000 (or at least the present value of the amount)

The Lease

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As a practical matter, Draper and Kramer may want to waive damages as an incentive to Johnny to release the building immediately

Chapter 11

- The basic idea is that Johnny's Restaurant can then proceed to get protection from its creditors.
- No creditor can then proceed to foreclose on the business, and Johnny is then allowed to propose a plan of organization.
- He is then free to seek a way keep the business going.

Debtor In Possession

- During this period of reorganization, he can continue to borrow money.
- Thus he can call up the next day and order more food from his supplier. The supplier knows that he may or may not be paid for past due bills, but he will certainly be paid for any future bills. (What about Famous Dan's Pies? We are getting ahead of the story).

Creditor Classes

- The creditors are organized according to who would be paid off first.
- Here the "ranks" would probably be:
  - Internal Revenue Service
  - 87th National Bank
  - Acme Venture Capital (2nd mortgage)
  - Unsecured Creditors including Draper and Kramer, who will presumably find their lease cancelled.

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- Each class of creditor is free to approve or disapprove his plan.
- If all the creditors approve it, the bankruptcy judge will order the plan carried out.

Cramming it Down

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- The IRS and the 87th National Bank get $10,000 and $50,000 respectively, because that is all they would be able to do in a simple Chapter 7.

Famous Dan’s Pies

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- To preserve going concern value, we must pay Famous Dan's Pies off.

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Is this Hicks Kaldor Optimal? Yes

Losers

- The same argument does not apply to Dapper Frank's Linen Service. There are other linen services, and Frank is just about out of luck.
- Ditto to Draper and Kramer. As a practical matter, they will simply lick their wounds and try to do as best as they can with their building.

The Employees

- The employees may also recover because of their blackmail ability. If Johnny has to bring in a new crew, the quality of the restaurant will decline during the training period.

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Is this Hicks Kaldor Optimal? Probably

End