

JUDGE DONOVAN'S DISCLOSURE STATEMENT REVIEW AND APPROVAL PROCEDURE

The judge generally employs the following system for reviewing chapter 11 disclosure statements:

When we receive a disclosure statement (and objections), the law clerk looks over the papers and drafts a memorandum of decision outlining all the significant objections, her/his own objections, and her/his recommended response to each objection. The judge reviews the papers and the draft, makes a decision on each objection, adds his own, and inserts an overall comment as to the general quality of the proponent's proposal along with instructions for remediation and further hearing. The direct participants are notified by phone and fax by the law clerk. Usually, no hearing is necessary, though no request for a hearing has been denied. Rarely, Judge Donovan requires a hearing. After the hearing date, the memorandum of decision may be revised and then is signed, entered, and mailed out.

The judge believes this procedure is considerably less time consuming and more helpful to the participants than discussing the objections and proposed changes at a hearing. In our experience, this system typically leads to faster, more effective and economical disclosure statement approval and plan confirmation, especially if debtor's lawyers are doing a conscientious job of representing their client.

Attached is an example of a memorandum of decision documenting (1) strong disapproval and (2) that an order to show cause will be issued based on substantive deficiencies in the proposed disclosure statement. Names of the parties, the case number and dates have been redacted to avoid embarrassing anybody.

Occasionally, unfortunately, a proposed disclosure statement is an unmitigated disaster. In that event, the judge may reject the disclosure statement outright without a detailed memorandum of decision but simply with an order containing instructions for remediation and an order to show cause why the case should not be dismissed or converted.

8/12/09

NOTE: This is a copy of a disclosure statement memorandum of decision. Docket numbers, names of parties and dates have been changed to avoid embarrassing anybody. Altered or deleted names and numbers are shown in brackets.

UNITED STATES BANKRUPTCY COURT
CENTRAL DISTRICT OF CALIFORNIA

In re

[ABC DEVELOPERS, INC.]

Debtor.

Case No. LA[___ - ____]TD

Chapter 11

MEMORANDUM OF DECISION
RE: THE DEBTOR'S ORIGINAL
DISCLOSURE STATEMENT; AND
ORDER

DATE: [_____]

TIME: 11:00 a.m.

PLACE: Courtroom 1345

CONTINUED HEARING DATE:

DATE: [_____]

TIME: 11:00 a.m.

PLACE: Courtroom 1345

The Debtor filed a voluntary chapter 11 petition on [_____]. This is a single asset real estate case and the Debtor has proposed a Plan of Reorganization (plan). The court has received objections to approval of the Debtor's Original Disclosure Statement (disclosure statement) from the Office of the United States Trustee (OUST), and from two secured creditors: the [County] and the [Bank]. These

1 objections convincingly reflect that the disclosure statement is seriously deficient.

2 Section 1125 governs approval of a disclosure statement. Section 1125(b) states
3 that

4 [a]n acceptance or rejection of a plan may not be solicited . . . from a holder
5 of a claim or interest with respect to such claim or interest, unless, at the time
6 of or before such solicitation, there is transmitted to such holder the plan or
summary of the plan, and a written disclosure statement approved after
notice and a hearing, by the court as containing adequate information.

7 Section 1125 governs approval of a disclosure statement. Section 1125(a)(1)
8 provides:

9 "adequate information" means information of a kind, and in sufficient detail,
10 as far as is reasonably practicable in light of the nature and history of the
debtor and the condition of the debtor's books and records, that would
11 enable a hypothetical reasonable investor typical of holders of claims or
interests of the relevant class to make an informed judgment about the plan .

12 . . .

13 The court finds the disclosure statement to lack adequate information and hereby
14 continues the matter to afford the Debtor an opportunity to amend and improve upon the
15 content of the disclosure statement, as well as the plan. Aside from the detailed
16 corrections that need to be made pursuant to the objections sustained as outlined below,
17 the disclosure statement needs to present to creditors a more comprehensive, objective
18 view of the factors that will have an effect on any prospective reorganization.

19 **Objections of the OUST**

20 The OUST does not believe that the disclosure statement contains "adequate
21 information". All of the OUST's objections are sustained and the disclosure statement must
22 be amended in light of these objections.

23 1. The technical errors and inconsistencies in the disclosure statement need to be
24 amended.

25 2. The disclosure statement should be amended to explain why the Debtor filed its
26 bankruptcy petition in the Central District of California, despite the fact that it operates
property located in [a distant state].

1 3. The status of [John Doe's] ownership interest in the Debtor and his involvement
2 in management of the Debtor under the plan, if any, needs to be fully disclosed in a
3 comprehensive manner, as opposed to the present piecemeal fashion. The Debtor also
4 needs to explain [John Doe's] past and present relationship to the Debtor and any related
5 entities in order to assist creditors to better understand why [John Doe] has refused to
6 provide certain financial statements to the Bank and to sign certain documents for
7 extension of the Bank loan.

8 4. The disclosure statement should be amended to include the definition of
9 "Effective Date".

10 5. The disclosure statement must be amended to explain, specifically, why Classes
11 Three and Four are "not impaired".

12 6. Disclosure is required regarding whether the security deposits, which are listed
13 as priority unsecured claims pursuant to §507(a)(6), have been segregated, the exact
14 amount of such security deposits collected, as well as the exact amount of such claims.
15 The court adds to the OUST's objection that the disclosure statement should provide the
16 language of [distant] state law that will determine the payment of such claims.

17 7. The description of the treatment of Class Six needs to be amended to indicate
18 whether payments are to be monthly, quarterly, annually or some other time interval.

19 8. The Debtor is proposing to cram down on non-consenting classes. If more than
20 50% of Class Six agrees to receive payment of 60% of their claim, then that whole class
21 would be paid 60% of their claim. At the same time, interest holders (Class Seven) retain
22 100% of their interest. This appears to violate the absolute priority rule. The disclosure
23 statement and the plan must account for this possible violation and the disclosure
24 statement must explain to creditors, in a clear, comprehensible fashion, what the violation
25 is and whether and how the Debtor's plan is feasible and confirmable despite the violation.

26 9. The partnership administration fee is disclosed to be \$12,500 each quarter. The

1 disclosure statement should describe what services are provided entitling [X Properties,
2 Inc. (XP)], the Debtor's general partner, to this fee. Also, the disclosure statement should
3 clarify that [XP] will suspend its "administrative fee" until all creditors are paid in full.

4 10. Classes Two and Three are undersecured. The plan appears to treat them
5 differently than other unsecured creditors, absent the 1111(b) election. This is a violation of
6 §1122(b) and must be addressed and/or amended in both the plan and the disclosure
7 statement.

8 11. The disclosure statement needs to discuss the circumstances of all of the notes
9 and amounts due and how they will be treated under the plan. Specifically, the balance
10 sheet dated 9/30/97 lists as a liability a note due to "GP" in the amount of \$70,000 which is
11 not included in the plan and is not disclosed anywhere in the disclosure statement. The
12 same is true for the \$100,000 listed as a liability owed to "Affiliates". The identity and
13 nature of the relationship(s) of the "Affiliates" to the Debtor also should be disclosed. To
14 the extent that any amounts have been paid to these apparently related persons in the
15 year prior to filing, those amounts also should be disclosed.

16 12. Both the disclosure statement and the plan need to address the calculation and
17 payment of post-confirmation quarterly fees and clearly state who the responsible parties
18 for payment will be.

19 13. The Debtor indicates that any shortfall of necessary funds will be made up from
20 a loan by [XP]. There needs to be a discussion of [XP's] financial condition and the
21 wherewithal of [XP] to make those loans. In addition, under §723, the chapter 7 trustee has
22 certain rights against the general partner. Therefore, the assets and liabilities of [XP] must
23 be disclosed and considered in any liquidation analysis.

24 **Objections of the County**

25 The County's objection to the interest rate of 6% on payment of its claim pursuant to
26 the plan is sustained. However, the County's suggestion of an interest rate of 10% will not

1 be imposed on the Debtor by the court absent evidence that 10% is a reasonable rate.

2 **Objections of the Bank**

3 The Bank has taken the position that the court should deny approval of the
4 disclosure statement because it fails to provide “adequate information” and is premised on
5 an unconfirmable plan. The Bank’s objections with respect to the disclosure statement’s
6 failure to provide adequate information are sustained and must be addressed by the
7 Debtor in amending the disclosure statement.

8 1. The Debtor must completely describe the low-income housing tax credit program,
9 as well as the Form 8609 Low Income Housing Credit Allocation Certification (Form 8609),
10 and disclose the impact of both on the plan. Accordingly, there must be full disclosure of
11 the Debtor’s past and present status with respect to such tax credits and issuance of the
12 Form 8609, as well as the probability that the Debtor will become eligible for use of such
13 credits and/or the Form 8609. A complete and coherent explanation of any disputes or
14 problems involving the Debtor, which have or will affect the tax credits and/or issuance of
15 the Form 8609 is also required. More specifically, the Debtor must address the allegations
16 made by the Bank with respect to these issues and why the Bank believes the Debtor has
17 been precluded from obtaining permanent financing to date.

18 2. Considering that the heart of the plan is the Debtor’s ability to obtain a
19 permanent “take out” loan, the Debtor has failed to disclose sufficient information to permit
20 creditors to make a reasoned decision concerning plan feasibility or whether the plan
21 provides for an adequate means of implementation or to evaluate whether confirmation is
22 likely to be followed by liquidation of the need for future financial reorganization. The court
23 concurs strongly with this objection and will not approve the disclosure statement absent
24 coherent and full disclosure of such critical information.

25 The Debtor must amend the disclosure statement to provide all information
26 regarding the procedure to obtain such a loan, as well as what the Debtor has done and/or

1 will do to obtain such a loan and why the Debtor believes that it will succeed in doing so.
2 Moreover, the disclosure statement must set forth, in detail, a time line for the steps the
3 Debtor will take to obtain the loan and what will happen if the Debtor fails to do so by a
4 definite date. The disclosure statement must clarify who the “back-up take-out lenders”
5 are. The Debtor alleges to have “arranged to pursue” with such lenders if the loan with
6 [ABC Mortgage Co.] falls through. The disclosure statement also must set forth whether
7 and why the Debtor will be able to perform under such loan (or any loan, for that matter),
8 in light of the Debtor’s history of defaults under present loans.

9 3. The disclosure statement must explain in detail how the Debtor will raise
10 between \$400,000 and \$700,000 in additional equity to secure “take-out” financing from a
11 new source. In order for creditors to estimate the feasibility and possibility of success of
12 this plan, complete and specific disclosure of the following is required: who are the
13 securities brokers and investors who gave the Debtor a “positive response about
14 refinancing options and further syndication of the tax credits to raise this additional equity”
15 and exactly what were their comments; who will further syndicate the tax credits; whether
16 existing equity holders or other investors will purchase the tax credits; and any current
17 commitments to infuse additional capital.

18 4. References in the disclosure statement to different fair market valuations of the
19 subject property must be supported by admissible evidence.

20 5. The disclosure statement must be further supplemented with historical and
21 projected financial information concerning the Debtor and, specifically, the operating
22 income and expenses of the subject property.

23 **Additional Comments of the Court**

24 1. The supporting affidavit of [Sam Smith] is fragmentary, piecemeal, evasive and
25 inadequate. All factual statements in the disclosure statement must be supported by a
26 complete, unqualified declaration executed by the principal(s) of the Debtor under penalty

1 of perjury .

2 2. The Debtor should fully disclose the nature of the County's secured claim.

3 3. The disclosure statement must be amended to clearly state the full amount of
4 each claim.

5 4. Exhibits B, C and D are incomplete and confusing. The exhibits must be
6 amended to provide accurate information that is consistent with the information provided in
7 the body of the disclosure statement.

8 5. All pages of the disclosure statement, including attached exhibits, must be
9 numbered consecutively at the bottom of each page pursuant to Local Rule 1002-1(4)(c).

10 6. The Debtor failed to satisfy the notice requirements for approval of a disclosure
11 statement pursuant to Fed. R. Bankr. P. 2002(b)(1). The Debtor must comply with all
12 notice requirements for future hearings.

13 **Conclusion**

14 The Debtor is required to amend the disclosure statement pursuant to the
15 aforementioned rulings. Furthermore, in light of the serious substantive deficiencies
16 outlined above, an order to show cause will be entered by the court. The hearing on
17 approval of the Debtor's disclosure statement and the status conference hearing are
18 continued to [_____] at 11:00 a.m. The Debtor is directed to file and serve both red-lined
19 and clean copies of its First Amended Disclosure Statement on the OUST, the Bank and
20 the County, and to provide conformed courtesy copies delivered to chambers no later than
21 [_____]. Objections to the First Amended Disclosure Statement shall be filed, with
22 conformed courtesy copies to chambers, no later than [_____].

23
24 DATED: [_____]

25 /s/
26 THOMAS B. DONOVAN
United States Bankruptcy Judge

ORDER

IT IS SO ORDERED.

DATED: [_____]

/s/
THOMAS B. DONOVAN
United States Bankruptcy Judge