IN THE UNITED STATES BANKRUPTCY COURT FOR THE EASTERN DISTRICT OF TENNESSEE

In re

Case No. 04-32926

LARRY D. GRAVES

Debtor

MEMORANDUM ON ADEQUACY OF THE DEBTOR'S SECOND AMENDED DISCLOSURE STATEMENT

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RICHARD STAIR, JR.
UNITED STATES BANKRUPTCY JUDGE

Before the court is the Debtor's Second Amended Disclosure Statement filed April 8, 2005 (Second Amended Disclosure Statement). Three objections to the adequacy of the Second Amended Disclosure Statement have been filed, as follows: (1) the Objection to Second Amended Disclosure Statement filed by BG Stayin Alive Properties, LLC (BGSA) on April 13, 2005; (2) John L. Turley's Objection to Debtor's Second Amended Disclosure Statement filed by John L. Turley (Turley) on April 21, 2005; and (3) the Objection by First Peoples Bank to Adequacy of Debtor's Second Amended Disclosure Statement filed by First Peoples Bank on April 22, 2005 (collectively Objections).[1] The Debtor filed his Response to the Restated Objections to the Debtor's Second Amended Disclosure Statement (Response) on April 26, 2005. The court held a hearing on the adequacy of the Second Amended Disclosure Statement and the Objections on April 28, 2005, and the decision was reserved for ruling on the existing record without further hearing.

This is a core proceeding. 28 U.S.C.A. § 157(b)(2)(A), (O) (West 1993).

I

The Debtor's Second Amended Disclosure Statement was filed in connection with his Second Amended Plan of Reorganization (Second Amended Plan), which was filed on April 11, 2005. The Second Amended Plan divides the Debtor's creditors into the following fourteen separate classes: (1) Class 1, consisting of administrative expenses in the approximate amount of $10,000.00, which will be paid in full upon the effective date of the plan unless otherwise agreed to; (2) Class 2, consisting of the fees paid to the United States Trustee in the amount of $250.00 to be paid in full on or before the effective date of the plan; (3) Class 3, consisting of any unpaid taxes owed to the Internal Revenue

[1] The United States Trustee filed an Objection to the Debtor's Disclosure Statement on March 10, 2005. On April 21, 2005, based upon the Debtor's Second Amended Disclosure Statement, the United States Trustee withdrew his Objection.

Service in the amount of $44,304.00 to be paid in full upon the effective date of the plan; (4) Class 4, consisting of any unpaid taxes owed to the Tennessee Department of Revenue, estimated at $0.00; (5) Class 5.1, consisting of any taxes owed to the Tennessee Department of Labor and Workforce, estimated at $0.00; (6) Class 6.1, consisting of the secured claim of Branch Banking & Trust in the amount of $6,436.42, to be paid by the Debtor's former wife; (7) Class 6.2, consisting of the claim of Citizens Bank of Blount County in the amount of $26,224.10, secured by 100,000 shares of Idleaire stock, with payment to be made in full within 30 days of the stock market value of Idleaire stock reaching $20.00 or in month 25, whichever is sooner; (8) Class 6.3, consisting of the claim of Ford Motor Credit evidenced by a Lease of a 2002 Lincoln with the Debtor to cure any default by the effective date of the plan and assume the Lease; (9) Class 6.4, consisting of the claim of Citizens Bank of Blount County in the amount of $53,389.25, secured by 100,000 shares of Idleaire stock with payment in full to be made within 30 days of the stock market value of Idleaire stock reaching $20.00 or in month 25, whichever is sooner; (10) Class 6.5, consisting of the contingent claim of John Turley in the amount of $117,000.00 related to his guarantee of a loan from First Peoples Bank to Conehead Properties, LLC, with the guarantee secured by 30,000 shares of Idleaire stock; (11) Class 7.1, consisting of the Debtor's allowed unsecured nonpriority claims in the aggregate amount of $894,971.54 with these claims to be paid in full from the proceeds of the sale of Idleaire stock when the market price exceeds $20.00 per share or in month 25, whichever comes first, or to be distributed pro rata if the net funds are insufficient to pay 100%; (12) Class 7.2, consisting of the contingent claims of First Peoples Bank in the aggregate amount of $2,501,000.00 related to guarantees of the Debtor with this claim to be paid in full under Class 7.1 upon any default of the principal obligation and notice of a balance due; (13) Class 7.3, consisting of the disputed claim of BGSA, in the amount

of $1,000,000.00, which the creditor contends is secured by 100,000 shares of Idleaire stock; and (14) Class 8, consisting of the Debtor's interest.

The Debtor proposes to fund the Second Amended Plan by selling 145,000 shares of Idleaire stock, presently worth $5.00 per share, for $2,900,000.00, supplemented with the commissions he receives as a licensed real estate agent and any recovery received from the estate of Dave Thomas (Thomas Estate) stemming from a lawsuit for alleged fraudulent misrepresentation in connection with the Debtor's $146,000.00 investment in "e-campus.com." Out of the fourteen separate classes of creditors, payment of the claims of six of the classes depends entirely upon the sale of the Idleaire stock.

BGSA's Objection is based upon its contention that the Second Amended Disclosure Statement: (1) does not reflect the actual shares of the Idleaire stock owned by the Debtor; (2) does not state that the Debtor's interest in BGSA is an option that has been rejected; (3) does not disclose that all previous forecasts as to the value of the Idleaire stock have been grossly inflated; (4) does not disclose the reasons for the decrease in the value of the Idleaire stock; (5) does not attach Idleaire's most recent Securities and Exchange Commission reports or other proof to show the substantial increase in value of the stock projected by the Debtor as necessary to fund the Second Amended Plan; (6) mistakenly states that the Debtor's guarantee to Citizens Bank of Blount County has not been "relieved" as a result of his settlement agreement with BGSA; (7) fails to disclose the purpose of the settlement agreement with BGSA, and his rationale for rejecting it; (8) does not disclose that he was released by BGSA for misappropriation of funds from refinancing made on behalf of BGSA; (9) fails to state that if he was not released by BGSA, it would seek to find any debts owed to it by the Debtor were nondischargeable; and (10) incorrectly states that the Debtor owns 145,000 shares of Idleaire

stock, when he sold 15,000 shares to BGSA, thereby reducing his actual holdings to 130,000 shares. BGSA also states that the Debtor's tax returns should be completed and available for review to determine the Debtor's true financial position. Finally, BGSA argues that the Debtor's Second Amended Plan is not based upon any true reorganization of his finances or businesses.

Turley's Objection states that the Second Amended Disclosure Statement does not adequately address the following items: (1) that the Debtor only owns 15,000 unencumbered shares of Idleaire stock; (2) the option to reacquire contained in the Stock Purchase Agreement; (3) the parameters under which the Idleaire stock can be sold prior to or during the term of the Second Amended Plan in the event of a material decline in market price; (4) the potential contribution claims of the co-guarantors of the First Peoples Bank loans to Conehead Properties, LLC, in the event that the co-guarantors pay off the loans; (5) the litigation costs, including administrative claims, and disposition of any recovery in connection with the litigation against the Thomas Estate; (6) the disposition of the Debtor's anticipated gross surplus from his projected 2006-2007 income; (7) any pending real estate or business transactions which may generate income to the Debtor, post-confirmation and during the term of the Second Amended Plan, including the disposition of such income; and (8) the source of funds to pay Classes 1 - 5.1 upon confirmation, considering the Debtor's limited amount of cash on hand.

First Peoples Bank avers that the Second Amended Disclosure Statement contains the following deficiencies: (1) it does not specify when the 25-month time frame referred to in the Second Amended Plan will commence; (2) it incorrectly states that a few of the notes owed to First Peoples Bank are not current, when most are substantially past due; and (3) it is inconsistent with respect to the pendency of post-petition litigation concerning the BGSA claim. Finally, First Peoples Bank

argues that the court should not approve the Second Amended Disclosure Statement because the Second Amended Plan is not feasible and is based upon speculation as to the future value of the Idleaire stock.

In his Response, the Debtor asserts that the Second Amended Disclosure Statement is adequate and discloses all information questioned by BGSA, Turley, and First Peoples Bank. The Debtor also argues that many of the concerns raised in the Objections are argumentative and should be disregarded, while others are confirmation issues and should not be considered in connection with the adequacy of the Second Amended Disclosure Statement.

II

Adequacy is governed by 11 U.S.C.A. § 1125(b), which provides that:

> An acceptance or rejection of a plan may not be solicited after the commencement of the case under this title from a holder of a claim or interest with respect to such claim or interest, unless, at the time of or before such solicitation, there is transmitted to such holder the plan or a summary of the plan, and a written disclosure statement approved, after notice and a hearing, by the court as containing adequate information. The court may approve a disclosure statement without a valuation of the debtor or an appraisal of the debtor's assets.

11 U.S.C.A. § 1125(b) (West 2004). As it pertains to § 1125, subsection (a) provides the following definitions:

> (a) In this section—
>
> > (1) "adequate information" means information of a kind, and in sufficient detail, 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 enable a hypothetical reasonable investor typical of holders of claims or interests of the relevant class to make an informed judgment about the plan, but adequate information need not include such information about any other possible or proposed plan; and

> (2) "investor typical of holders of claims or interests of the relevant class" means investor having—
>
> > (A) a claim or interest of the relevant class;
> >
> > (B) such a relationship with the debtor as the holders of other claims or interests of such class generally have; and
> >
> > (C) such ability to obtain such information from sources other than the disclosure required by this section as holders of claims or interests in such class generally have.

11 U.S.C.A. § 1125(a) (West 2004).

The court determines adequacy on a case-by-case basis, considering the following non-exhaustive list in making its determination:

> (1) the circumstances that gave rise to the filing of the bankruptcy petition; (2) a complete description of the available assets and their value; (3) the anticipated future of the debtor; (4) the source of the information provided in the disclosure statement; (5) a disclaimer, which typically indicates that no statements or information concerning the debtor or its assets or securities are authorized, other than those set forth in the disclosure statement; (6) the condition and performance of the debtor while in Chapter 11; (7) information regarding claims against the estate; (8) a liquidation analysis setting forth the estimated return that creditors would receive under Chapter 7; (9) the accounting and valuation methods used to produce the financial information in the disclosure statement; (10) information regarding the future management of the debtor, including the amount of compensation to be paid to any insiders, directors, and/or officers of the debtor; (11) a summary of the plan of reorganization; (12) an estimate of all administrative expenses, including attorneys' fees and accountants' fees; (13) the collectibility of any accounts receivable; (14) any financial information, valuations or *pro forma* projections that would be relevant to creditors' determinations of whether to accept or reject the plan; (15) information relevant to the risks being taken by the creditors and interest holders; (16) the actual or projected value that can be obtained from avoidable transfers; (17) the existence, likelihood and possible success of non-bankruptcy litigation; (18) the tax consequences of the plan; and (19) the relationship of the debtor with affiliates.

In re Scioto Valley Mortgage Co., 88 B.R. 168, 170-71 (Bankr. S.D. Ohio 1988) (citations omitted). "In short, a proper disclosure statement must clearly and succinctly inform the average unsecured creditor

what it is going to get, when it is going to get it, and what contingencies there are to getting its distribution." *In re Ferretti*, 128 B.R. 16, 19 (Bankr. D.N.H. 1991).

Generally, other issues are left for confirmation; however, in the appropriate case, the court may determine that a disclosure statement is inadequate "where it describes a plan of reorganization which is so fatally flawed that confirmation is impossible." *In re Cardinal Congregate I*, 121 B.R. 760, 764 (Bankr. S.D. Ohio 1990).

> Courts generally have agreed that it may, on occasion, be appropriate to consider issues at the disclosure hearing stage which could otherwise be raised at confirmation, if the described plan is fatally flawed so that confirmation would not be possible:
>
> > If the disclosure statement describes a plan that is so "fatally flawed" that confirmation is "impossible," the court should exercise its discretion to refuse to consider the adequacy of disclosures. Such an exercise of discretion is appropriate because undertaking the burden and expense of plan distribution and vote solicitation is unwise and inappropriate if the proposed plan could never legally be confirmed.
> >
> > The question whether a plan meets requirements for confirmation is usually answered at confirmation hearings. Where the plan's inadequacies are patent, they may, and should be addressed at the disclosure statement stage. Disclosure hearings anticipate, but do not preempt, confirmation hearings. Accordingly, the disclosure statement should be disapproved at the threshold only when the plan it describes displays fatal facial deficiencies or the stark absence of good faith.

In re Phoenix Petroleum Co., 278 B.R. 385, 394 (Bankr. E.D. Pa. 2001) (quoting *In re E. Maine Elec. Co-op, Inc.*, 125 B.R. 329, 333 (Bankr. D. Maine 1991) (internal citations omitted)).

> As the approval of the adequacy of a disclosure statement is an absolute prerequisite to soliciting acceptances or rejections of a plan of reorganization [11 U.S.C. § 1125(b)], a plan is in limbo until such approval is obtained. A body of jurisprudence has developed which suggests that notwithstanding adequate disclosure of information required by section 1125(b), a disclosure statement should not be approved if the proposed plan, as a matter of law, cannot be confirmed.
>
> The reasoning behind such holding is obvious—the estate should not be burdened (both in terms of time and expense) with going through the printing, mailing, noticing, balloting,

> and other exercises in the confirmation process where inability to attain confirmation is a *fait accompli*.

In re Allied Gaming Mgmt., 209 B.R. 201, 202 (Bankr. W.D. La. 1997) (internal citations omitted); *see also In re Beyond.com Corp.*, 289 B.R. 138, 140 (Bankr. N.D. Cal. 2003) (refusing to approve a disclosure statement because the underlying plan was "patently unconfirmable"); *In re Mahoney Hawkes, LLP*, 289 B.R. 285 (Bankr. D. Mass. 2002) (same); *In re Silberkraus*, 253 B.R. 890, 899 (Bankr. C.D. Cal. 2000) ("[W]here a plan is on its face nonconfirmable, as a matter of law, it is appropriate to deny approval of the disclosure statement describing the nonconfirmable plan."); *In re O'Leary*, 183 B.R. 338, 338-39 (Bankr. D. Mass. 1995) ("Courts may refuse to approve disclosure statements that describe plans that cannot be confirmed.").

"While the funding of a plan is usually a consideration that is reserved for confirmation, [courts] have on occasion ruled that 'it is proper to consider and rule upon such issues prior to confirmation, where the proposed plan is arguably unconfirmable on its face.'" *In re Petit*, 189 B.R. 227, 228 (Bankr. D. Maine 1995) (quoting *In re Main Road Properties, Inc.*, 144 B.R. 217, 219 (Bankr. D.R.I. 1992)). In *Petit*, the debtor's plan proposed to pay creditors with the speculated recovery from a pending lawsuit, which at least one expert valued in excess of $30 million. In refusing to approve the disclosure statement, the court made the following observation:

> It is by dangling so many zeroes before creditors who have nothing else to lose, that the Debtor has been able to maintain their continuing support of her unrealistic reorganization efforts. It is a fact of life, however, that while there is no statutory requirement that creditors be realistic or reasonable in their expectations of success, the Court does not enjoy such latitude, and neither may we permit the Debtor to fantasize indefinitely.

Petit, 189 B.R. at 228.

Such is also the case here. The Debtor proposes to fund the Second Amended Plan through his annual salary of $60,000.00, an alleged claim against the Thomas Estate in the amount of $146,000.00, and by selling 145,000 shares of Idleaire stock for $2,900,000.00 notwithstanding that the stock is presently valued at $5.00 per share, *i.e.*, $725,000.00. With respect to the Idleaire stock, the Debtor's Second Amended Disclosure Statement provides that "[t]he stock will be sold as soon as the shares reach a market price of $20 or in month 25 at the market price at that time." DISCLOSURE STMT. at 10. He projects the Idleaire stock to rise from its current $5.00 per share value to $10.00 in 2005, between $20.00 and $25.00 in 2006, and between $25.00 and $30.00 in 2007. These projections are based upon the prospectus developed for Idleaire's current management by Lattimore Black Morgan & Cain, which indicates that in 2007, the price per share is expected to be $22.99. Currently, however, the Debtor acknowledges that the company's privately-traded stock is worth $5.00 per share, the price set by Idleaire in October 2004, when it offered up to 10,000,000 in new shares to raise additional capital.

Even though the Debtor's Second Amended Plan states that it will be funded from three sources, the truth is that the success of the Second Amended Plan is based entirely upon the Debtor's ability to sell the Idleaire stock at the purely speculative value of $20.00 per share. As stated by the Debtor, the current market value of the 145,000 shares is $725,000.00, which he acknowledges will not fund the Second Amended Plan. The Debtor purchased 450,000 shares in 2000 for $250,000.00, translating to $.56 per share; an amount representing 11.2% of the stocks' present $5.00 per share value. There is no guarantee, however, that the stock will even retain its $5.00 value over the next

two years, much less, that it will actually increase by the 400% required by the Debtor to fund the Second Amended Plan.[2]

Likewise, funding based upon the pre-petition lawsuit against the Thomas Estate for alleged fraudulent misrepresentation and recovery of the Debtor's investment loss of $146,000.00 with respect to the Debtor's "e-campus.com" investment is purely speculative. There is no guarantee that the Debtor will prevail in this lawsuit. Additionally, according to the Second Amended Disclosure Statement, the Debtor has not earned any commissions from the sale of any real property since June 1, 2004, the date of filing. Without actual proof that the Debtor has a means by which to fund the Second Amended Plan, it is patently unconfirmable, and even though the Debtor acknowledges these risks in the Second Amended Disclosure Statement, such disclosure does not remedy the deficiencies of the Second Amended Plan. Accordingly, the court cannot approve the Second Amended Disclosure Statement because the underlying Second Amended Plan is fatally flawed. The court will therefore not approve the Second Amended Disclosure Statement and will direct the Debtor to show cause why his Chapter 11 case should not be converted or dismissed, whichever is in the best interest of creditors.

[2] The Debtor argues, under his liquidation scenario, that he will have to pay capital gains taxes if forced to sell the stock now. He then acknowledges, in the Income/Stock Value Projection, that "[i]t is expected that capital gains tax will run 15% depending on loss carry forwards available." In any event, whether the Debtor sells the stock now or in 25 months, he will be required to pay capital gains taxes.

An order consistent with this Memorandum will be entered.

FILED: May 4, 2005

BY THE COURT

s/ Richard Stair, Jr.

RICHARD STAIR, JR.
UNITED STATES BANKRUPTCY JUDGE

IN THE UNITED STATES BANKRUPTCY COURT FOR THE EASTERN DISTRICT OF TENNESSEE

In re

Case No. 04-32926

LARRY D. GRAVES

Debtor

O R D E R

For the reasons stated in the Memorandum on Adequacy of the Debtor's Second Amended Disclosure Statement filed this date, the court directs the following:

1. The Second Amended Disclosure Statement filed by the Debtor on April 8, 2005, is not approved.

2. The Debtor shall appear before the court on May 26, 2005, at 10:00 a.m., in Bankruptcy Courtroom 1-C, First Floor, Howard H. Baker, Jr. United States Courthouse, Knoxville, Tennessee, to show cause why this Chapter 11 case should not be converted to Chapter 7 or dismissed, whichever is in the best interest of creditors.

3. The clerk shall serve this Order on the Debtor, Debtor's attorney, United States Trustee, creditors, and all parties in interest.

SO ORDERED.

ENTER: May 4, 2005

BY THE COURT

s/ Richard Stair, Jr.

RICHARD STAIR, JR.
UNITED STATES BANKRUPTCY JUDGE