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Recommended Citation

Kennedy, Cornell; Ramsey, Phylinda; and Rayburn, Kevin, "Movie Gallery" (2012). *Chapter 11 Bankruptcy Case Studies*. 27.

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Netflix Killed the Video Store: The Death and Resurrection of Movie Gallery

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Table of Contents

| | |
|--|----|
| Introduction..... | 3 |
| Business Information..... | 3 |
| Business Model..... | 4 |
| Economic Decline..... | 4 |
| Chapter 11 Filing..... | 6 |
| Proposal Overview..... | 7 |
| Leases..... | 8 |
| Compelling Assumption or Rejection..... | 9 |
| Motion for Relief from Automatic Stay..... | 10 |
| Preference and Recovery of Pre-Petition Payment..... | 14 |
| Pre-Petition Debt and Collateral..... | 18 |
| DIP Post-Petition Financing..... | 19 |
| Claim Litigation..... | 24 |
| Disclosure Statement..... | 27 |
| The Final Plan..... | 28 |
| Outcome..... | 31 |
| Conclusion..... | 32 |

Netflix Killed the Video Store: The Death and Resurrection of Movie Gallery

“The guilty may fear, but no vengeance he aims
At the honest man's life or Estate
His wrath is entirely confined to wide frames
And to those that old prices abate”

- Luddite Song: “General Ludd’s Triumph”

1. Introduction:

Luddites were not acting out of a fear of technology, they were acting out of self-preservation. It seems that the world is currently filled with sectors of business fighting tooth and nail to stay in existence. Their efforts are futile because the only true path to perpetuity is through adaptation. When a new technology or new *modus operandi* develops, those who adapt survive. Those who don’t are doomed to fail. Newspapers that resisted utilizing the internet are losing subscribers in droves. Automobile manufacturers who refused to build “green” cars are begging the Government to bail them out. Video rental stores who didn’t see the value in streaming media and mail delivery service are filing for bankruptcy. Movie Gallery went from being the big dog, engaging in a large-scale acquisition of a competitor, to being the hare falling behind the tortoise in the race. This paper tells the tale of Movie Gallery’s downfall into bankruptcy and its emergence back into the cruel world of early adopters and Luddites.

2. Background Information:

Movie Gallery, Inc. was founded in 1985 with its headquarters are in Dothan, Alabama.¹ Movie Gallery is the second largest North American video rental company with approximately 3,490 stores in all 50 U.S. states and Canada operating under the brands Movie Gallery, Hollywood Video, and Game Crazy (collectively “Movie Gallery”).² Since Movie Gallery’s initial public offering in August 1994, the Company has grown from 97 stores to its present size through acquisitions and new store openings.³ In 2005, Movie Gallery completed its largest acquisition to date with the Hollywood Entertainment merger.⁴ This combination of companies increased the store total to 4,700

¹ Movie Gallery, http://en.wikipedia.org/wiki/Movie_Gallery (last visited May 5, 2009).

² *Id.*

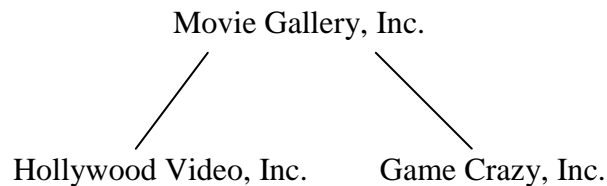
³ *Id.*

⁴ *Id.*

with revenues in excess of \$2.5 billion.⁵ In addition, Movie Gallery strengthened its presence with 61 new stores in Western Canada with the acquisition of VHQ Entertainment.⁶ The Game Crazy brand represents 550 in-store departments and 11 free-standing market locations across the U.S. in the urban area.

i. Business Model:

Movie Gallery is a home video business with its principal focus on the rental and sale of DVD, VHS movies, and video games.⁷ The Movie Gallery subsidiary stores operating under the Movie Gallery brand primarily target small towns and suburban areas.⁸ With its focal point on rural areas and secondary markets, the Company is able to contend with small and independently owned chain stores.⁹ With these strategic plans, the Company is able to take advantage of greater purchasing economics and effective labor strategies.¹⁰ However, the Hollywood subsidiary stores operating under the Hollywood Video and Game Crazy brands largely target large urban centers and suburban areas.¹¹ In the larger marketplace, the Company focuses on customer service and in-store execution to remain competitive.¹²



ii. The Economic Decline:

As has recently been the case with so many long-term successful businesses, Movie Gallery has been greatly affected economically by internet/on-line sales. Movie Gallery filed for Chapter 11 bankruptcy (reorganization) protection in Oct. 2007, hoping to turn around an operation having problems competing with online movie rentals from both Netflix and Blockbuster's Total Access Program.¹³ In the past few years customers

⁵ *Id.*

⁶ *Id.*

⁷ Movie Gallery, About Movie Gallery, <http://www.moviegallery.com/company/about.aspx> (last accessed May 5, 2009).

⁸ *Id.*

⁹ *Id.*

¹⁰ *Id.*

¹¹ *Id.*

¹² *Id.*

¹³ Beth Gatson Moon, *Hollywood Video parent Movie Gallery files for Chapter 11 bankruptcy*, Blogging Stocks, Oct. 16, 2007, <http://www.bloggingstocks.com/2007/10/16/hollywood-video-parent-movie-gallery-files-for-chapter-11-bankru/>

have increasingly turned to using on-line movie rentals instead of the traditional in-store movie rentals.

In addition to competing with on-line video sales, two years ago both Blockbuster and Movie Gallery were competing to buy the Hollywood Video chain: a competition which Movie Gallery regrettably won. Movie Gallery paid \$1 billion to acquire Hollywood Entertainment, but has struggled to pay \$1.4 billion of debt it incurred from the acquisition.¹⁴ Under the terms of the merger agreement with Movie Gallery, Hollywood's shareholders were entitled to receive \$13.25 per share in cash at closing. Hollywood's entry into the merger agreement with Movie Gallery occurred at the conclusion of an auction process led by a Special Committee of Hollywood's Board of Directors comprised of all of the independent directors of Hollywood's Board of Directors, during which the Special Committee solicited interest among a broad range of potential corporate and financial buyers. The auction process was conducted during the period following the execution of the October 13, 2004 amended and restated merger agreement with Carso Holdings Corporation, an affiliate of Leonard Green & Partners, L.P., the terms of which expressly allowed Hollywood to solicit alternative transactions. Under the terms of the merger agreement with Carso, Hollywood's shareholders were to receive \$10.25 per share in cash. The \$13.25 per share price that were received by Hollywood's shareholders under the terms of the merger agreement with Movie Gallery represents a 30% premium over the \$10.25 price negotiated with Carso.¹⁵

Subsequently, Movie Gallery's stock plummeted 25% and it closed more than 500 stores in an effort to consolidate assets.¹⁶ Even with the steps taken to maximize profits and close unprofitable stores, Movie Gallery decided that the best solution would be to proceed with a Chapter 11 filing.¹⁷

(last accessed Apr. 16, 2009) (Blockbuster's Total Access Program is an on-line service that allows its customers to purchase rentals via internet).

¹⁴ Scott Riddle, Movie Gallery Files Chapter 11 Bankruptcy, Oct, 17, 2007, <http://www.georgiabankruptcyblog.com/archives/news-and-comments-movie-galleryfiles-chapter-11-bankruptcy.html> (last accessed May 4, 2009).

¹⁵ <http://ir.hollywoodvideo.com/phoenix.zhtml?c=69069&p=irolnewsArticle&t=Regular&id=660669&>

¹⁶ Scott Riddle, Movie Gallery Files Chapter 11 Bankruptcy, Oct, 17, 2007, (last accessed May 4, 2009).

¹⁷ In addition, Movie Gallery had loan extensions that ended September 30th, 2007. See Cindy Spielvogel, Movie Gallery Files Chapter 11 Bankruptcy, Oct. 16, 2007, <http://www.videobusiness.com/article/CA6491552.html>

Movie Gallery Revenue¹⁸

| 2003 | 2004 | 2005 | 2006 | 2007 |
|----------------|---------------|------|-----------------|-----------------|
| \$ 629,793,000 | \$729,167,000 | | \$2,030,251,000 | \$1,828,002,000 |

Movie Gallery Stock Price Over Time¹⁹



3. Chapter 11 Filing:

After most loan extensions had lapsed²⁰, its stock had plummeted to around 23 cents, its current debt was at \$1.4 billion, and its assets were only worth \$892 million, Movie Gallery decided to go ahead with a prenegotiated restructuring agreement in a Chapter 11 with its secured creditors. Movie Gallery's management hoped bankruptcy would not be necessary with the various decisions made to reduce debt and increase profits by closing unprofitable stores, staff reductions, and maximizing capital. For example, within months prior to filing its Chapter 11, Movie Gallery's management sought to take numerous steps to reduce their debt and strengthen their balance sheet through closing unprofitable stores, headcount reductions and other means, but these actions were not sufficient to offset the cost of their substantial debt obligations. Furthermore, these actions were not sufficient to compensate for the significant shift to

¹⁸ Movie Gallery Inc., Annual Report (Form 10-K), at 26 (2005); Movie Gallery Inc., Annual Report (Form 10-K), at 81 (2008).

¹⁹ Yahoo Finance, Movie Gallery Inc. (MOVIQ) [http://finance.yahoo.com/echarts?s=MOVIQ.PK - chart16:symbol=moviq.pk;range=19940811,20080327;indicator=volume;charttype=line;crosshair=off;ohlcvvalues=0;logscale=off](http://finance.yahoo.com/echarts?s=MOVIQ.PK-chart16:symbol=moviq.pk;range=19940811,20080327;indicator=volume;charttype=line;crosshair=off;ohlcvvalues=0;logscale=off) (last accessed May 5, 2009).

²⁰ Cindy Spielvogel, Movie Gallery Files Chapter 11 Bankruptcy, Oct. 16, 2007, <http://www.videobusiness.com/article/CA6491552.html>

online rentals and the debt obligations that had accrued through the acquisition of Hollywood Video.

4. Proposal Overview:

Movie Gallery's major factor to its Chapter 11 filing was its more than \$1 billion in debt to numerous creditors.²¹ With its proposal, Movie Gallery would restructure its debt to eradicate \$400 million of debt and reduce future interest expenses such as paying employee wages and health benefits.²² This negotiated proposal would allow for Movie Gallery's leading creditor, Sopris Capital, to invest \$50 million in Movie Gallery.²³ Another \$72 million of the Movie Gallery's \$175 million in second-lien debt, which was held by Sopris Capital, would be converted into new equity.²⁴ Moreover, the plan would allow for \$325 million in bonds and other unsecured claims to be converted into equity in the reorganized Company.²⁵ Movie Gallery's existing shares of equity and common stock would be cancelled.²⁶ The terms for the remaining \$103 million second-lien debt as well as the first-lien debt would be amended.²⁷ Movie Gallery also arranged a debtor-in-possession ("DIP") financing agreement, discussed below, that would allow the Movie Gallery to use \$150 million of post-petition credit. These funds would allow Movie Gallery to pay vendors and employees in order to remain a going concern.

The plan would also allow for payment to vendors for purchases made after the date of the filing. However, several studios have filed motions to receive payment for purchases made prior to the date of the filing. Thereafter, Movie Gallery filed a motion for an order to set an expedited hearing on these motions and for relief. The Court ruled that an expedited hearing on the First Day Motions was appropriate under these circumstances and is consistent with past practices in virtually every significant Chapter 11 case, where various relief is required at the outset of the case to ensure a smooth transition into Chapter 11.²⁸ Considering timely access of the relief requested in the First Day Motions was critical to maintaining Movie Gallery's ongoing operations and the value of their bankruptcy estates.²⁹

²¹Dawn McCarty and Josh Fineman, *Movie Gallery Seeks Bankruptcy Protection Amid Losses*, Oct. 17, 2007, <http://www.bloomberg.com/apps/news?pid=20601087&sid=aLMH0yeIAano&refer=home>.

²²*Id.*

²³*Id.*

²⁴*Id.*

²⁵*Id.*

²⁶*Id.*

²⁷*Id.*

²⁸*See* Motion by the Debtors for an Order Setting an Expedited Hearing on "First Day Motions" and for Related Relief, *In re Movie Gallery, Inc.*, No. 07-33849 (Bankr. E.D. Va. Nov. 20, 2007).

²⁹*Id.*

Movie Gallery has also assumed some leases while rejecting others. Movie Gallery requested approval to reject 212 unexpired leases on vacant stores that cost Movie Gallery about \$15.4 million per year.³⁰ Movie Gallery's request was approved on the basis that it was the best interest for the Debtors, the estate, and the creditors.³¹ This ruling was correct in that it allowed Movie Gallery to be relinquished from debt in unprofitable locations and was an essential step in beginning their rehabilitation process. Movie Gallery proposed that the lease auctions would save about \$69.4 million a year.³² Moreover, considering several of these unexpired leases were in unprofitable locations, rejecting these leases would be an essential part of the reorganization plan to alleviate unnecessary drains on resources.

Movie Gallery has retained Los Angeles-based auction Great American Group to help sell inventory at the locations that are closing.³³ Movie Gallery proposed that for several locations that are unprofitable it would be more cost-effective to auction off the leases instead of subleasing. The lease payments for the stores range from \$14,400 to \$235,000 per year.³⁴ Movie Gallery plans to auction the leases for 508 of the 520 store locations it plans to close.³⁵

5. Leases:

An essential part of Movie Gallery's Plan of Reorganization ("Plan") was its use of Section 365 to reject multiple leases at store locations that were unprofitable. Instead of assuming most of the leases, Movie Gallery found it to be a more productive use of capital to reject these leases in its Plan and utilize the revenue to compete with its competitors with on-line sales.

Bankruptcy Code ("Code") Section 365 is an interesting and complex section of the Code. Section 365(a) provides that "the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor."³⁶ Depending on whether the contract has value or is a burden to the estate determines whether the

³⁰Dawn McCarty and Josh Fineman, *Movie Gallery Seeks Bankruptcy Protection Amid Losses*, Oct. 17, 2007, <http://www.bloomberg.com/apps/news?pid=20601087&sid=aLMH0yeIAano&refer=home>.

³¹ *See Order Approving and Authorizing Expungement of Claims Related to Leases that have been Assumed by the Reorganized Debtor, In re: Movie Gallery, INC., et al.*, No. 07-33849 (Bankr. E.D. Va. Nov. 20, 2007).

³² Dawn McCarty and Josh Fineman, *Movie Gallery Seeks Bankruptcy Protection Amid Losses*, Oct. 17, 2007, <http://www.bloomberg.com/apps/news?pid=20601087&sid=aLMH0yeIAano&refer=home>.

³³ Erin Killian, *Movie Gallery to close 400 stores*, Feb. 5, 2008, <http://www.bizjournals.com/washington/stories/2008/02/04/daily23.html> ("Great American Group is a liquidation and downsizing specialist.")

³⁴ *Id.*

³⁵ *Id.*

³⁶ 11 U.S.C. § 365 (2008).

trustee will assume or reject the contract. If the trustee decides to assume the contract, all of the obligations under the contract are assumed.

The trustee or debtor in possession must assume or reject an executory contract or unexpired lease in full. In bankruptcy, these types of contracts can be used as a threat of rejection in order to negotiate better terms on leases.

The debtor is allowed to assign leases, but has to accommodate several obligations first. For instance, an unexpired lease of nonresidential real property under which the debtor is the lessee shall be deemed rejected, and the trustee shall immediately surrender that nonresidential real property to the lessor, if the trustee does not assume or reject the unexpired lease by the earlier of the date that is 120 days after the date of the order for relief; or the date of the entry of an order confirming the plan.

i. Compelling Assumption or Rejection:

While a debtor-in-possession typically has 120 days after the order for relief is entered to assume or reject an unexpired lease of nonresidential real property, a court may, on the request of a party-in-interest, order the assumption or rejection of such lease within a specified period of time, especially if the debtor has committed post-petition monetary defaults.³⁷ This was the case for several of Movie Gallery's unexpired leases. Movie Gallery was in monetary default for many of its unexpired leases and some of the lessors requested an order to have their lease assumed or rejected.

For example, BJS Sunshine LLC ("BJS"), by counsel, a lessor and party-in-interest, filed a motion less than 30 days after the petition date, but before the 356(d)(4) deadline for order compelling assumption or rejection of an unexpired nonresidential real property lease because Movie Gallery failed to fully perform its post-petition payment due for November 2007 and all subsequent payment obligations under the lease after Movie Gallery filed its bankruptcy petition on October 16, 2007.³⁸

BJS requested this motion shortly after the order for relief was granted and requested the Court to compel Movie Gallery to assume or reject the lease within 10 days of the hearing on the motion, and in the event the lease was not rejected, requiring Movie Gallery to timely perform all post-petition lease obligations under 11 U.S.C. 365(d)(3).³⁹

Movie Gallery objected to this motion by submitting that the debtors reserved their rights to seek extensions of the 120-day period provided by Section 365(d)(4). This provides the debtor with an extension of 90 days in order to exercise its judgment on the

³⁷ See 11 U.S.C. §§105 and 365(d)(3).

³⁸ See Motion by BJS for Entry of an Order (1) Compelling Assumption or Rejection of Unexpired Nonresidential Real Property Lease, (2) Requiring Post-Petition Performance of All Lease Obligations and (3) Granting Adequate Protection, *In re Movie Gallery, Inc.*, et al., No. 07-33849 (Bankr. E.D.V.A. Nov. 20, 2007).

³⁹ *Id.*

disposition of their leases of nonresidential real property.⁴⁰ The Court ruled that the debtors had satisfied their obligations under Section 365(d)(3).

After Movie Gallery had requested and been approved by the Court to auction off 508 of its stores leases, several shopping center landlords filed motions objecting to this grant because Movie Gallery had begun store closing and violating lease agreements prior to the bankruptcy filing.⁴¹ However, the Court ordered that it would be in the best interest of the debtors' estate to allow it to reject and auction off their leases requested.⁴²

6. Motion for Relief from Automatic Stay:

One of the initial and automatic effects of a company filing for bankruptcy is the automatic stay imposed by 11 U.S.C § 362.⁴³ As the name implies, the stay is effective as soon as filing for bankruptcy is complete. One of the specific actions stayed under § 362 are any litigation proceedings that were commenced before the filing of the bankruptcy. However, the Bankruptcy Court can grant relief from the automatic stay for the benefit of a creditor if the creditor shows "cause".⁴⁴

⁴⁰ Debtor's Objection to BJS Sunshine LLC's Motion for Order (1) Compelling Assumption or Rejection of Unexpired Nonresidential Real Property Lease, (2) Requiring Post-Petition Performance of All Lease Obligations and (3) Granting Adequate Protection, *In re Movie Gallery, Inc.*, et al., No. 07-33849 (Bankr. E.D.V.A. Dec. 11, 2007). BJS later withdrew their motion. Consent Order Withdrawing Motion for Order (1) Compelling Assumption or Rejection of Unexpired Nonresidential Real Property Lease, (2) Requiring Post-Petition Performance of All Lease Obligations and (3) Granting Adequate Protection, *In re Movie Gallery, Inc.*, et al., No. 07-33849 (Bankr. E.D.V.A. Feb. 20, 2008).

⁴¹ Cindy Spielvogel, *Movie Gallery Files Chapter 11 Bankruptcy*, Oct. 16, 2007, <http://www.videobusiness.com/article/CA6493789.html>

⁴² *See generally* Order Authorizing the Assumption on May 12, 2008 of Certain Unexpired Leases of Non-Residential Real Property, *In re Movie Gallery, Inc.*, et al., No. 07-33849 (Bankr. E.D. Va. May 8, 2007) (explaining the reasons for assuming the leases and providing a complete list of them).

⁴³ *See* 11 U.S.C. § 362(a) (listing specifically the types of actions and processes that are stayed under § 362). In order to be granted relief from the automatic stay, an interested party has to file a motion. A motion is a "contested matter" and is not like a civil lawsuit. *See* FED. R. BANKR. P. 9014 (explaining a motion and the notice requirements). Also, FED. R. BANKR. P. 4001 governs the motion for relief from stay specifically. The notice requirements for FED R. BANKR. P. 9014 have to be met. *See* FED. R. BANKR. P. 4001.

⁴⁴ *See* 11 U.S.C. § 362(d) (explaining that the Bankruptcy Court can "terminat[e], modif[y], annul[], or condition[] the stay at the request of a party). Also, "cause" is not defined in the Code. *See id.*

i. William Nixon’s Motion for Relief from Automatic Stay:

In March 25, 2008, William Nixon (“Mr. Nixon”), a resident of North Carolina, filed a motion for relief from stay. Mr. Nixon had a pending civil litigation case involving slander.⁴⁵ He was an employee at Facility Master, a Florida Company under contract with Movie Gallery to inspect Detex bars in Movie Gallery stores.⁴⁶ On October 30, 2004, Mr. Nixon was at a store in Illinois working when employees of Movie Gallery acting as representatives of the company accused Mr. Nixon of “an indictable offense”.⁴⁷ He requested relief from stay so that they could enter mediation, finish discovery, and resolve the case.⁴⁸ The Motion itself was simple. First, the history of the pending civil litigation was outlined.⁴⁹ Then, the moving party outlined the relief sought.⁵⁰ The Motion summarized the standard for “cause” outlined by the Fourth Circuit in regards to pending litigation.⁵¹

The standard cited for “cause” states “courts must balance potential prejudice to the bankruptcy debtor’s estate against the hardships that will be incurred by the person seeking relief from the automatic stay if relief is denied.”⁵² Further, the Motion listed relevant factors to include in determining whether cause including: (1) whether the issues in the pending litigation involve only state law, so the expertise of the bankruptcy court is unnecessary; (2) whether modifying the stay will promote judicial economy and whether there would be greater interference with the bankruptcy case if the stay were not lifted because matters would have to be litigated in bankruptcy court; and (3) whether the estate can be protected by a requirement that the creditors seek

⁴⁵ Motion for Relief From the Automatic Stay, *In re Movie Gallery, Inc.*, No. 07-33849, (Bankr. E.D. Va. Mar. 25, 2008). Initially, on October 27, 2006, Mr. Nixon commenced a civil action in the Circuit Court of Montgomery County, Alabama, against Movie Gallery, Inc.; Movie Gallery US LLC, Movie Gallery Services INC., and MGA, INC. seeking actual and punitive damages for acts constituting Slander and Intentional Interference With Business Relations. The brief facts stated in the Motion explained that Mr. Nixon worked for a company contracted to inspect Movie Gallery facilities. On one such visit, the employees of Movie Gallery made false statements to Mr. Nixon’s employer resulting in his dismissal. *Id.* at 1-4. Specifically, Mr. Nixon filed for relief from stay to allow certain litigation to proceed under 11 U.S.C. § 362(d)(1). *Id.* at 1.

⁴⁶ *Id.* at 2.

⁴⁷ *Id.* at 2-3.

⁴⁸ In addition the motion states that Mr. Nixon had already performed some discovery and taken significant steps legally. *Id.* at 6.

⁴⁹ *Id.* at 3,4. In question is a writ of mandamus by Movie Gallery to transfer venue at the Supreme Court level in Alabama and the civil suit in the trial court of Montgomery County Alabama that is “at issue and ripe for adjudication”. Mr. Nixon requested in the Motion that he be allowed to litigate the civil suit and the writ of mandamus. *Id.* at 3, 4, 6.

⁵⁰ *Id.* at 5,6.

⁵¹ *Id.* at 5.

⁵² *Id.* (citing *In re: Robbins*, 964, F2d. 342, 345, (4th Circuit 1992).

enforcement of any judgment through the bankruptcy court.⁵³

Mr. Nixon asserted that the issues of Slander and Intentional Intervention in Business relations involved only state law and did not involve the federal bankruptcy law; thus, satisfying the first factor. He also asserted that the resolution of the litigation would facilitate the bankruptcy through knowledge of the claim amounts asserted against the debtor and would not harm the bankruptcy estate. Also, Mr. Nixon claimed he would be greatly harmed because of the mental pain sustained by him and that further delay would only increase his financial and mental suffering.⁵⁴

ii. Debtor's objection to Mr. Nixon's proof of claim:

On March 8, 2008, Movie Gallery, Inc., ("debtors") had filed an objection to Mr. Nixon's proof of claim.⁵⁵ The Debtors asserted that under 11 U.S.C. § 502(b) they were allowed to object to the claim for relief and, thus, disallow it.⁵⁶ The inability of the moving party to specify an amount for their claim, the debtors argued, invalidated the claim. The debtors asserted that the moving party should specify a certain amount and disclose that amount to the debtors and the court.⁵⁷ The debtors wanted to expunge the claim completely.⁵⁸

The Debtors explained that as part of the "Solicitation Procedures" Mr. Nixon, through a resolution event, could be eligible to vote on the proposed plan for reorganization.⁵⁹ The eligibility to vote would not entitle Mr. Nixon to distributions.⁶⁰

⁵³ *Id.* at 5.

⁵⁴ *Id.* Another point of interest is the notice to the other parties attached to the end of the motion. The notice warned the other parties that they may be affected and stated a deadline for entering a motion in regards to the motion for stay. *Id.* at 7.

⁵⁵ Debtors' Amended Objection To William Nixon's Proof Of Claim No. 2646, *In re Movie Gallery, Inc.*, No. 07-33849, (Bankr. E.D. Va. Mar. 8, 2008). On January 18, 2008, Mr. Nixon filed a proof of claim in the amount of ninety million dollars against Movie Gallery for the state court claims. Agreed Order Modifying Plan Injunction With Respect to William Nixon Solely as Set Forth Therein, No. 07-33849, pg. 2, (Bankr. E.D. Va. Feb. 20, 2009).

⁵⁶ Debtors' Amended Objection To William Nixon's Proof Of Claim No. 2646, No. 07-33849, pg. 3, (Bankr. E.D. Va. Mar. 8, 2008). *See* 11 U.S.C. § 502(a) (stating in relevant part "[a] claim or interest . . . is deemed allowed, unless a party in interest . . . objects.").

⁵⁷ Debtors' Amended Objection To William Nixon's Proof Of Claim No. 07-33849, (Bankr. E.D. Va. Mar. 8, 2008).

⁵⁸ *Id.* The moving party later filed a response to the debtors' proof of claim motion. The moving party argued that the lack of a specific amount did not qualify the claim to be expunged, but qualified the claim to be amended. Notice and Response in Opposition to Debtor's Objection and Amended Objection to William Nixon's Proof of Claim -2646 (Apr. 4, 2008).

⁵⁹ Debtors' Amended Objection To William Nixon's Proof Of Claim No. 07-33849, pg. 8, (Bankr. E.D. Va. Mar. 8, 2008).

⁶⁰ *Id.* at 9.

Although the claim was in dispute, the Debtors were willing to give Mr. Nixon the right to vote on the plan for reorganization.

In response to the motion for relief from stay, the court entered an order and an amended order. Both the amended order and the order stated that the automatic stay imposed by § 362(a) would remain in full effect until July 9, 2008.⁶¹ However, on May 20, 2008 the plan for reorganization became effective which permanently enjoined Mr. Nixon from pursuing his claim.⁶² On July 9, 2008 a Notice of Continuance was filed that would allow Mr. Nixon and the debtors to continue negotiations and talks on how to proceed with the actions.⁶³

The Agreed Order Modifying Plan Injunction With Respect to William Nixon is the final resolution explaining how Mr. Nixon's claim will be allowed to proceed. The court allowed Mr. Nixon to pursue the state court claim in Montgomery County, which effectively modified the automatic stay.⁶⁴ However, for the suit to proceed Movie Gallery must be able to use insurance proceeds to pay defense costs and indemnify Movie Gallery.⁶⁵ Further, any judgment awarded can only be paid out of available insurance proceeds, if any, that lists the debtors as insureds and may not be asserted against Movie Gallery or its estate.⁶⁶

Additionally, if any judgment is awarded and the insurance proceeds cannot pay for the entire sum, the remaining is absolved and cannot be asserted against the debtor or its estate.⁶⁷ The Agreed Order allowed Mr. Nixon to proceed with his claim, but it placed important conditions on the proceeding of the suit. As a result, Mr. Nixon is allowed to proceed, but he will be limited by the ability of the insurance proceeds to pay for Movie Gallery's defense costs and the judgment amount. The court dismissed Mr. Nixon's claim⁶⁸ and allowed him to proceed as a means of removing the claim against the debtor's estate because now any judgment can only be collected out of the insurance proceeds.

iii. A Rare Instance: Movie Gallery filed for a relief from stay itself to proceed with pending litigation

In an unusual turn of events, Movie Gallery itself filed for relief from automatic stay.⁶⁹ The motion for relief involved two separate lawsuits brought against Movie

⁶¹ Amended Agreed Order Delaying Termination of Stay by Operation of 11 U.S.C. § 362(e) (Bankr. E.D. Va. May 21, 2008); Agreed Order Delaying Termination of Stay By Operation of 11 U.S.C. §362(e) (Bankr. E.D. Va. Apr. 24, 2008).

⁶² Agreed Order Modifying Plan Injunction With Respect to William Nixon Solely as Set Forth Therein, No. 07-33849, pg. 3, (Bankr. E.D. Va. Feb. 20, 2009).

⁶³ *Id.*

⁶⁴ *Id.* at 4,5.

⁶⁵ *Id.* at 4,5.

⁶⁶ *Id.* at 4,5.

⁶⁷ *Id.* at 4,5.

⁶⁸ *Id.* at 6.

⁶⁹ Motion of the Debtor's for an Order Modifying the Automatic Stay to Permit Certain Litigation to Proceed, No. 07-33849, (Bankr. E.D. Va. Nov. 26, 2007).

Gallery in Alabama and Georgia.⁷⁰ Tiffany's Movies and C.J.'s Video Plus ("the Whitakers") collectively commenced a suit on July 20, 2005 against Movie Gallery on RICO charges in Georgia.⁷¹ The Whitakers stated that Movie Gallery's sale of pornographic materials in conjunction with other stores selling those materials was a violation of the RICO laws.⁷²

Movie Gallery subsequently on August 23, 2005 filed a motion to dismiss and for attorney's fees to the district court and both motions were affirmed on appeal.⁷³ The motion for attorney's fees was remanded to the district court.⁷⁴ However, the determination of damages had yet to be made when Movie Gallery filed for bankruptcy, and the automatic stay prevented the debtors from obtaining attorney's fees.⁷⁵ The debtors outlined the relevant factors for modifying the automatic stay and concluded that all of the factors fell in favor of modification.⁷⁶ However, the most important factor was that the debtor's estate would actually benefit because of the awarding of attorney's fees.⁷⁷

Summarily, the automatic stay's purpose is to protect the estate of the debtor so that certain creditors do not receive more than others. *In re Movie Gallery, Inc.*, the motions discussed show the force of the automatic stay. Mr. Nixon is allowed to pursue his claim, but the limitations imposed could severely affect the proceeding. His judgment is limited to the amount of insurance proceeds he can collect, and if there is a remainder, then he is not allowed to state a claim against Movie Gallery. While Mr. Nixon is allowed to pursue his state court claim, he is limited in his recovery, potentially severely.

7. Preference and Recovery of Pre-Petition Payment:

Under the bankruptcy code, a trustee is able to avoid and recover a payment made by the debtor to a creditor before the petition date.⁷⁸ These payments are called "preferences." Section 547 lists the prima facie elements that the trustee must prove to avoid a preference:

⁷⁰*Id.* at 4-6. The suit commenced in Alabama was on the same grounds as the Whitaker suit: RICO charges for selling pornographic materials in conjunction with other stores. However, the Alabama suit had not progressed as far as the Whitaker suit, but the debtors were still asking for relief from stay because they believed that they could obtain attorney's fees from the Alabama plaintiffs since both suits were based on frivolous claims. *Id.*

⁷¹ *Id.*

⁷² *Id.* at 20.

⁷³ *Id.* at 4-6.

⁷⁴ *Id.*

⁷⁵ *Id.* at 5-9.

⁷⁶ *Id.*

⁷⁷ *Id.*

- 1) That the payment was “to or for the benefit of the creditor”
- 2) The payment was made for a debt that existed prior to the petition date
- 3) The payment was made while the debtor was insolvent
- 4) The payment was made within 90 days prior to the petition date
- 5) The creditor received more than it would have if the payment had not been received and the debtor was liquidated under chapter 7 bankruptcy.⁷⁹

Further, Section 550 states that a trustee can recover the value of any transfer avoided under Section 547.⁸⁰

There are several motivating factors behind Sections 547 and 550; however, the most important factor is the desire to protect the whole pool of creditors.⁸¹ In a bankruptcy proceeding, generally the creditors share pro rata, but this principle would be defeated if the debtor was allowed to pay off certain creditors and not others pre-petition.⁸² As a result, the trustee, acting as plaintiff, is allowed to take back preferential payments to creditors made pre-petition to enlarge the pool of available money to split pro rata between all the creditors.⁸³

The action for a preference differs from other matters in a bankruptcy proceeding because it is an adversary proceeding. An adversary proceeding is a lawsuit in bankruptcy court. The Federal Rules of Bankruptcy Procedure Section 7001 states that a proceeding to recover money or property is an adversary proceeding and is governed by the 7000 series of the Federal Rules of Bankruptcy Procedure.

i. Preference payments to vendor-creditors

One of the most common reasons for a preference is payment to a vendor-creditor.⁸⁴ *In re Movie Gallery, et al.*, most of the avoidance actions filed by the trustee were against vendors who received payment pre-petition.⁸⁵ The complaint first stated the

⁷⁸ See 11 U.S.C. §§ 547, 550.

⁷⁹ JONATHAN P. FRIEDLAND ET AL., CHAPTER 11 – THE NUTS AND BOLTS OF CHAPTER 11 PRACTICE: A PRIMER 105 (2007).

⁸⁰ 11 U.S.C. § 550 (2008). As evident, the trustee now has more power than the pre-petition debtor. They can avoid payments for the benefit of the pool of creditors. See FRIEDLAND, *supra* note 79, at 91.

⁸¹ See FRIEDLAND, *supra* note 79, at 94.

⁸² *Id.*

⁸³ *Id.*

⁸⁴ *Id.* at 105.

⁸⁵ *Movie Gallery, Inc. v. US Maintenance, Inc.*, 07-33849, (Bankr. E.D. Va. Dec. 29, 2009) (explaining that US Maintenance was a vendor and had received several

authority of the trustee to file these complaints.⁸⁶ After the court confirmed the Second Amended Joint Plan of Reorganization for Movie Gallery and it became effective on May 20, 2008, the MG Litigation Trust was formed that granted the trustee to pursue any claims under chapter five of the bankruptcy code.⁸⁷

Second, the trustee outlined four counts against the vendors.⁸⁸ The first count was brought under § 547 for the avoidance of preferential transfers made to the vendors ninety days before the petition date while the debtor was insolvent.⁸⁹ The trustee stated further that the transfers were for antecedent debt.⁹⁰ Also, the transfers resulted in the vendor receiving more than it would have if the debtor had been liquidated under chapter seven, had not received the payments, or had the creditors had received payment under title 11 of the United States Code.⁹¹ The second count stated that the estate was entitled to compensation in the amount of the transfers under Section 550.⁹²

prepetition payments that were subject to avoidance); *Movie Gallery, Inc. v. Tri- State Sheet Metal, Inc.*, 07-33849, (Bankr. E.D. Va. Dec. 29, 2009) (stating that a payment of \$14, 534. 00 was a preference and avoidable); *Movie Gallery, Inc. v. Drivesafe*, 07-33849, (Bankr. E.D. Va. Dec. 29, 2009) (stating that one payment of \$25, 640.00 was a voidable preference). The complaints were very similar in their layout except for the amount of the transfer and parties involved. *Id.* US Maintenance is a company that offers —facility management solutions. It is a company that manages the physical maintenance for other companies that have multiple locations. US Maintenance, <http://www.usmservices.com/> (last visited May 1, 2009).

⁸⁶ *Movie Gallery v. US Maintenance, Inc.*, 07-33849, (Bankr. E.D. Va. Dec. 29, 2009); Prior to the confirmation of the Second Amended Joint Plan of Reorganization, the debtors were acting as debtors in possession. *Id.* at 2. Pursuant to the Plan, the MG Litigation Trust was created whose responsibility is to receive and maintain the trust assets, oversee the liquidation, and distribute the assets to the beneficiaries of the trust. The trustee, William Kaye, was appointed as representative of the estate by the power of 11 U.S.C. §§ 1123(a)(5), (a)(7), and (b)(3)(B). *Id.* at 3.

⁸⁷ *Id.*;

⁸⁸ *Id.* at 4. The transfers were made within 90 days of the petition date, and the total amounted to \$16845,319.00

⁸⁹ *Id.* The transfers were made within 90 days of the petition date. *Id.* at 8. There is a presumption under § 547(f) that a company is insolvent 90 days before petitioning for bankruptcy, which satisfies one of the requirements for the prima facie case. *Id.* at 4.

⁹⁰ *Id.*

⁹¹ *Id.* at 4. Also, it is pertinent to note that the trustee walked down the requirements for a prima facie case and did so in a simple manner. *See id.*

⁹² *Id.* at 4-5. 11 U.S.C. § 550(1) (2008) (— to the extent that a transfer is avoided under section . . . 547 . . . of this title, the trustee may recover, for the benefit of the estate, the property transferred . . . the initial transferee or such transfer.)).

The third count stated that under Section 502(d) the vendor's claims were disallowed until the avoided transfers were repaid to the estate.⁹³ The fourth count was a request for interest that had accrued between the initial request for the transfers and the future judgment date.⁹⁴ It is interesting to note that the trustee plaintiff reserved the right to bring future claims arising out of these transfers if discovery yielded evidence of more preferential transfers.⁹⁵

Most of the preferences in the present case followed this exact pattern with the amounts and vendors differing. For example, US Maintenance had supposedly received over one hundred thousand dollars in pre-petition payments. Tri-State Sheet Metal and Drivesafe each received one payment pre-petition for the amounts of \$14, 534.00 and 25, 640.00, respectively.⁹⁶

| Payment Check Date | Payment Amount | Payment Vendor | Debtor |
|--------------------|----------------|----------------|-------------------------------------|
| 8/7/2007 | \$872.00 | Daystar USM | Hollywood Entertainment Corporation |
| 8/14/2007 | \$490.00 | Daystar USM | Hollywood Entertainment Corporation |
| 8/15/2007 | \$52,005.99 | Daystar USM | Hollywood Entertainment Corporation |
| 8/28/2007 | \$1,761.20 | Daystar USM | Hollywood Entertainment Corporation |
| 9/4/2007 | \$4,486.00 | Daystar USM | Hollywood Entertainment Corporation |
| 9/11/2007 | \$500.00 | Daystar USM | Hollywood Entertainment Corporation |
| 9/17/2007 | \$52,755.25 | Daystar USM | Hollywood Entertainment Corporation |
| 9/25/2007 | \$2,327.50 | Daystar USM | Hollywood Entertainment Corporation |

⁹³ *Id.* at 5. 11 U.S.C. § 502(d) (“the court shall disallow any claim of any entity from which property is recoverable under section . . . 547 . . . of this title, unless such entity has paid the amount . . .”). Since US Maintenance had not paid the claim amount, the court could disallow their claims against the debtor. *See id.*

⁹⁴ *Id.* at 5-6.

⁹⁵ *Id.* at 6.

⁹⁶ *Movie Gallery, Inc. v. Tri- State Sheet Metal, Inc.*, 07-33849, pg. Exh. A, (Bankr. E.D. Va. Dec. 29, 2009); *Movie Gallery, Inc. v. Drivesafe*, 07-33849, pg. Exh. A, (Bankr. E.D. Va. Dec. 29, 2009).

| | | | |
|--------------|--------------|-------------|-------------------------------------|
| 10/2/2007 | \$500.00 | Daystar USM | Hollywood Entertainment Corporation |
| 10/9/2007 | \$52,755.25 | Daystar USM | Hollywood Entertainment Corporation |
| Total | \$168,453.19 | | |

The chart summarizes the payments US Maintenance from Movie Gallery in the two months before Movie Gallery filed for bankruptcy.⁹⁷ It illustrates the point that payments made ninety days before the filing for bankruptcy are suspect and can be possibly avoided by the trustee. Also, currently only Tri- State Sheet metal has been dismissed and no action has been taken on the other two adversary proceedings.⁹⁸

As the adversary proceedings above illustrate, the trustee can try to avoid payments that were made pre-petition if they were made in the ninety-day window before filing. The trustee is trying to secure as much funds as possible to distribute to the creditors and avoidance of preferences is a powerful tool. In the present case, if the trustee is able to avoid all of the US Maintenance payments, the trustee will be able to distribute \$168, 453.19 dollars that he otherwise would not have had. Thus, the creditors in the bankruptcy proceeding can recoup more of their claim.

8. Pre-Petition Debt and Collateral:

Movie Gallery's debt as of September 30, 2007 was held by two groups of lenders: First Lien Lenders and Second Lien Lenders. Movie Gallery owed \$720,600,000 to the First Lien Lenders which consisted of:

- (1) \$597,000,000 (Term Loans);
- (2) \$100,000,000 consisting of:
 - a. revolving loans
 - b. swing line loans
 - c. letters of credit
 - d. interest, fees, and charges accrued;
- (3) 23,600,000 (Synthetic Letters of Credit); and
- (4) all interest, fees, and charges accrued.⁹⁹

⁹⁷ *US Maintenance*, at 2 (stating that the debtor's filed for bankruptcy on October 16, 2007). US Maintenance received the most in payments out of the three listed.

⁹⁸ *See Adversary Proceeding Closed, 03-08195, Dismissed, (Bankr. E.D. Va. Mar. 27, 2009).*

⁹⁹ Final Order Pursuant to 11 U.S.C. §§ 105, 361, 362, 363, 364(c), 364(d) and 364(e) and Fed. R. Bankr. P. 4001 and 9014 (I) Authorizing Debtors to Obtain Secured Post-

Movie Gallery owed \$175,000,000 to the Second Lien Lenders consisting of terms loans and all interest, fees, and charges accrued.¹⁰⁰ Both debts were in default as of the petition date which caused an increase in the respective interest rates, and the First Lien Creditor debt was accelerated.¹⁰¹

Movie Gallery's debt was secured with liens on all the collateral that existed immediately prior to the petition date ("Existing Collateral").¹⁰² The First Lien Lender's lien had priority over the Second Lien Lender's lien. Both lenders liens were oversecured on a going-concern basis.¹⁰³

9. DIP Post-Petition Financing:

Bankruptcy Code §364 authorizes the DIP to obtain post-petition financing, which is often necessary for the DIP to continue as a going concern during Chapter 11 Bankruptcy proceedings. Bankruptcy Code §364 provides four ways to obtain this financing.

First, §364(a) allows the DIP to obtain unsecured credit in the ordinary course of business. A lender's claim under §364(a) is a first-priority administrative expense.

Second, §364(b) allows the DIP to obtain unsecured credit outside of the ordinary course of business. A lender's claim under §364(b) is also a first-priority administrative expense. §364(b) is often unappealing to would be lenders because they are not afforded as much protection as they would under §364(c) and (d).

Third, if the DIP cannot obtain sufficient unsecured credit pursuant to §364(a) and (b), §364(c) allows the DIP to obtain credit that gives the creditor a super-priority administrative claim or a security interest in unencumbered assets (or a junior security interest in already encumbered assets). §364(c) would seem to suggest that a creditor will be granted either a super-priority administrative expense or a post-petition lien but

Petition Financing on Super-Priority Priming Lien Basis, Granting Adequate Protection for Priming and Modifying Automatic Stay, (II) Authorizing Debtors to Use Cash Collateral of Existing Secured Lenders and Granting Adequate Protection for Use, (III) Confirming Authorization for Debtors to Repay Existing Revolver Indebtedness Upon Interim Approval, pgs. 8-9, 07-33849, Nov. 16, 2007.

¹⁰⁰ *Id.* at 9.

¹⁰¹ *Id.*

¹⁰² *Id.*

¹⁰³ *Id.*

not both.¹⁰⁴ However, as is seen below with Movie Gallery, some creditors are given both protections.

Fourth, §364(d) allows the DIP to obtain credit that gives the creditor a security interest that is senior or equal to existing pre-petition security interests. A “priming lien” is when the post-petition creditor's interest is senior to an existing pre-petition creditor's security interest. Because of the great protections offered under §364(d), the pre-petition liens that are “primed” must be given adequate protection. In order for a DIP to obtain post-petition credit pursuant to §364(c) and (d), the DIP must show that it failed to obtain financing with lower priority protections.

i. Movie Gallery seeks and acquires DIP financing:

Soon after beginning Chapter 11 Bankruptcy proceedings, Movie Gallery represented to the court that it was in dire need of post-petition financing. Movie Gallery claimed that without post-petition financing, it would not be able to pay “post-petition payroll, payroll taxes, trade vendors, suppliers, overhead and other expenses necessary for the continued operation of Movie Gallery's businesses or the management and preservation of Movie Gallery's assets and properties.”¹⁰⁵

In total, Movie Gallery was granted \$150,000,000 of DIP post-petition financing through two orders: \$140,000,000 by an Interim Order on October 16, 2007 and \$10,000,000 by a subsequent Final Order on November 14, 2007.¹⁰⁶ Pursuant to the Interim and Final Orders, Movie Gallery must use the post-petition financing to repay in full the existing \$100,000,000 Revolving Loan owed to the First Lien Lenders. The remaining \$50,000,000 post-petition financing is to be used to keep Movie Gallery operational, preserve the value of Movie Gallery's assets, pay fees and expenses relating to the DIP financing, and make any other payments permitted under the Interim and Final Orders.¹⁰⁷

¹⁰⁴ JONATHAN P. FRIEDLAND ET AL., *THE NUTS AND BOLTS OF CHAPTER 11 PRACTICE: A PRIMER* 164-65 (2007).

¹⁰⁵ Final Order Pursuant to 11 U.S.C. §§ 105, 361, 362, 363, 364(c), 364(d) and 364(e) and Fed. R. Bankr. P. 4001 and 9014 (I) Authorizing Debtors to Obtain Secured Post-Petition Financing on Super-Priority Priming Lien Basis, Granting Adequate Protection for Priming and Modifying Automatic Stay, (II) Authorizing Debtors to Use Cash Collateral of Existing Secured Lenders and Granting Adequate Protection for Use, (III) Confirming Authorization for Debtors to Repay Existing Revolver Indebtedness Upon Interim Approval, pg. 12, 07-33849, Nov. 16, 2007.

¹⁰⁶ *Id.* at 2.

¹⁰⁷ *Id.* at 13.

Movie Gallery's post-petition lenders were granted super-priority administrative claim status pursuant to §364(c)(1), which is subordinate only to a carve-out.¹⁰⁸ In addition to the super-priority administrative claim status the post-petition lenders were granted liens. The post-petition lenders, through §364(c)(2), were granted first priority liens on all current and future collateral (“Post-Petition Collateral”) that was not already subject to liens.¹⁰⁹ Pursuant to §364(c)(3), the post-petition lenders were granted second priority junior liens on Post-Petition Collateral that was already subject to liens.¹¹⁰ Finally, subject to the adequate protections granted in the Final and Interim Orders, and pursuant to §364(d), the post-petition lenders were granted first priority senior priming liens on Existing Collateral (pre-petition collateral) unless the collateral in question already had a lien in which case a junior lien will be given to the post-petition lender.¹¹¹

This “priming” lien is not really a priming lien at all. As worded, nothing is being primed because the post-petition lenders are being given junior liens on any collateral that already had a lien. In reality this is a way to catch any collateral to which a security interest had not attached or been perfected. This approach saves the post-petition lenders time and money because they do not have to track down the collateral and can just use this general statement to cover any Existing Collateral that was not subject to a lien.

The Interim¹¹² and Final¹¹³ DIP financing orders (“DIP Financing Orders”) say that adequate protection is to be provided to the extent of any diminution of value of the First and Second Lien Lender’s interests in Existing Collateral resulting from:

¹⁰⁸ *Id.* at 17-18.

¹⁰⁹ *Id.* at 18.

¹¹⁰ *Id.*

¹¹¹ *Id.* 18-19.

¹¹² Interim Order Pursuant to 11 U.S.C. §§ 105, 361, 362, 363, 364(c), 364(d) and 364(e) and Fed. R. Bankr. P. 4001 and 9014 (I) Authorizing Debtors to Obtain Secured Post-Petition Financing on Super-Priority Priming Lien Basis, Granting Adequate Protection for Priming and Modifying Automatic Stay, (II) Authorizing Debtors to Use Cash Collateral of Existing Secured Lenders and Granting Adequate Protection for Use, (III) Authorizing Debtors to Repay Existing Revolver Indebtedness Upon Interim Approval and (IV) Prescribing Form and Manner of Notice and Setting Time for Final Hearing, 07-33849, Oct. 16, 2007.

¹¹³ Final Order Pursuant to 11 U.S.C. §§ 105, 361, 362, 363, 364(c), 364(d) and 364(e) and Fed. R. Bankr. P. 4001 and 9014 (I) Authorizing Debtors to Obtain Secured Post-Petition Financing on Super-Priority Priming Lien Basis, Granting Adequate Protection for Priming and Modifying Automatic Stay, (II) Authorizing Debtors to Use Cash Collateral of Existing Secured Lenders and Granting Adequate Protection for Use, (III) Confirming Authorization for Debtors to Repay Existing Revolver Indebtedness Upon Interim Approval, Nov. 16, 2007.

(i) the priming of their liens upon and security interests in the Existing Collateral by the liens and security interests granted to DIP Lenders to secure the Obligations pursuant to Section 364(d) of the Bankruptcy Code, (ii) the use of cash collateral pursuant to Section 363(c) of the Bankruptcy Code, (iii) the use, sale, lease, depreciation or other diminution in value of the Existing Collateral pursuant to Section 363(c) of the Bankruptcy Code and (iv) the imposition of the automatic stay pursuant to Section 362(a) of the Bankruptcy Code...¹¹⁴

Particular provisions of Sections 362, 363, and 364 of the Bankruptcy Code require creditors to be adequately protected. This protection “can take on many forms, including periodic cash payments to the secured lenders, payment of post-petition interest or the granting of additional liens to the creditor on previously unencumbered assets.”¹¹⁵ The Bankruptcy Code says such adequate protection can be provided by:

- (1) requiring the trustee to make a cash payment or periodic cash payments to such entity, to the extent that the stay under section 362 of this title, use, sale, or lease under section 363 of this title, or any grant of a lien under section 364 of this title results in a decrease in the value of such entity’s interest in such property;
- (2) providing to such entity an additional or replacement lien to the extent that such stay, use, sale, lease, or grant results in a decrease in the value of such entity’s interest in such property; or
- (3) granting such other relief... as will result in the realization by such entity of the indubitable equivalent of such entity’s interest in such property.¹¹⁶

The DIP Financing Orders provide adequate protection to Existing Lenders in 9 ways:

- 1) repayment of a revolving loan to First Lien Lenders;

¹¹⁴ Final Order Pursuant to 11 U.S.C. §§ 105, 361, 362, 363, 364(c), 364(d) and 364(e) and Fed. R. Bankr. P. 4001 and 9014 (I) Authorizing Debtors to Obtain Secured Post-Petition Financing on Super-Priority Priming Lien Basis, Granting Adequate Protection for Priming and Modifying Automatic Stay, (II) Authorizing Debtors to Use Cash Collateral of Existing Secured Lenders and Granting Adequate Protection for Use, (III) Confirming Authorization for Debtors to Repay Existing Revolver Indebtedness Upon Interim Approval, pg. 36, 07-33849, Nov. 16, 2007.

¹¹⁵ JONATHAN P. FRIEDLAND ET AL., THE NUTS AND BOLTS OF CHAPTER 11 PRACTICE: A PRIMER 32 (2007).

¹¹⁶ 11 U.S.C. § 361 (2008).

- 2) First Lien Lenders are granted super-priority administrative claims subordinated to the DIP Lenders' super-priority administrative claims and Second Lien Lenders are granted super-priority administrative claims subordinated to both the DIP Lenders' and First Lien Lenders' super-priority administrative claims (but proceeds from avoidance actions are to be shared pro rata with all holders of administrative expense claims);
- 3) First Lien Lenders are granted unavoidable liens on Collateral junior to the first-priority liens granted under the DIP Financing Orders to the DIP Lenders, and Second Lien Lenders are granted the same but their liens are also junior to the First Lien Lenders' liens;
- 4) First Lien Lenders are granted unavoidable liens on Collateral junior to the second-priority liens granted under the DIP Financing Orders to the DIP Lenders, and Second Lien Lenders are granted the same but their liens are also junior to the First Lien Lenders' liens;
- 5) Debtors are to pay the First Lien Lenders any and all unpaid fees relating to synthetic letters of credit and interest on the original debt that accrued after the petition date, and Debtors are to pay the First Lien Lenders monthly interest payments on the original debt along with pre-petition fees and fees as they accrue during the Cash Collateral Usage Period;
- 6) during the Cash Collateral Usage Period, Debtors are to pay the second Lien Lenders interest paid-in-kind on the original debt, any accrued pre-petition fees, and fees as they become due;
- 7) Debtors are to pay Existing Lenders' fees, costs, and charges within 20 days after the submission of invoices;
- 8) all the Debtors' motions and orders providing for the payment or satisfaction of pre-petition claims other than "first day" motions and orders are to be in the form and substance reasonable satisfactory to Goldman Sachs Credit Partners L.P., the First lien Lenders' administrative agent; and
- 9) no past or future administrative costs are to be asserted by the Debtors against the Existing Lenders;¹¹⁷

¹¹⁷ Final Order Pursuant to 11 U.S.C. §§ 105, 361, 362, 363, 364(c), 364(d) and 364(e) and Fed. R. Bankr. P. 4001 and 9014 (I) Authorizing Debtors to Obtain Secured Post-Petition Financing on Super-Priority Priming Lien Basis, Granting Adequate Protection for Priming and Modifying Automatic Stay, (II) Authorizing Debtors to Use Cash Collateral of Existing Secured Lenders and Granting Adequate Protection for Use, (III) Confirming Authorization for Debtors to Repay Existing Revolver Indebtedness Upon Interim Approval, pgs. 36-40, 07-33849, Nov. 16, 2007.

The DIP Financing Orders also authorized Movie Gallery to use the cash collateral of the First and Second Lien Lenders as long as they are adequately protected by:

- (1) payments of outstanding pre-petition and post-petition fees, costs, and charges incurred by both parties;
- (2) interest payments to First Lien Lenders;
- (3) paid-in-kind interest to Second Lien Lenders; and
- (4) other obligations of adequate protection previously mentioned above.¹¹⁸

10. Claim Litigation:

Most of the litigation revolved around Movie Gallery’s assumption of leases. When a lease is assumed, the DIP must cure defaults or provide assurance that it will cure the defaults.¹¹⁹ Many landlords filed objections to Movie Gallery’s proposed cure amounts. It is in the landlord’s best interest to have the claim amount to be as high as possible in order to obtain more money when the unsecured creditors are paid out pro-rata. Movie Gallery settled the cure amounts with many of the landlords; others required a court hearing. Ultimately, the court issued an order expunging all the claims of unexpired leases that were assumed by Movie Gallery.¹²⁰ The rejection of leases was accomplished with very few objections, and those few objections were resolved out of court and withdrawn.¹²¹

Movie Gallery had a number of objections to the myriad of proof of claims that were submitted by creditors to the court. Most of Movie Gallery’s objections concerned duplicative claims, claims that were incorrectly classified, and claims that were not sufficiently supported. As a result, Movie Gallery was successfully able to disallow and expunge a large number of claims. Others claims were merely reduced or reclassified to a different priority. Below is a table laying out Movie Gallery’s Omnibus Objections to claims and the court’s ruling:

| <u>Omnibus Objection to Claims</u> | <u>Reason</u> | <u>Ruling</u> | <u>Outcome</u> |
|--|---------------|---------------|----------------|
|--|---------------|---------------|----------------|

¹¹⁸ *Id.* at 3-4.

¹¹⁹ *See* 11 U.S.C. § 366(b)(1)(A) (2008); JONATHAN P. FRIEDLAND ET AL., THE NUTS AND BOLTS OF CHAPTER 11 PRACTICE: A PRIMER 191 (2007).

¹²⁰ Order Approving and Authorizing Expungement of Claims Related to Unexpired Leases that Have Been Assumed by the Reorganized Debtors, 07-33849-DOT, Dec. 23, 2008 (includes a table showing all the leases assumed and their cure amounts).

¹²¹ *See, e.g.*, Limited Objection of Shorey's, Inc. to Debtors' Notice of Tenth Omnibus Rejection of Certain Unexpired Leases, 07-33840, Mar. 24, 2008; Withdrawal of Limited Objection of Shorey's Inc. to Debtors' Notice of Tenth Omnibus Rejection of Certain Unexpired Leases, 07-33849 Mar. 25, 2008.

| | | | |
|------------|----------------------------|------------------------|-------------------------------|
| First | Duplicative Claims | Granted ¹²² | Disallow and Expunge |
| Second | Insufficient Documentation | Granted ¹²³ | Disallow and Expunge |
| Third | Duplicative Claims | Granted ¹²⁴ | Disallow and Expunge |
| Fourth | Books & Records | Granted ¹²⁵ | Reduce and Allow |
| Fifth | Insufficient Support | Granted ¹²⁶ | Disallow and Expunge |
| Sixth | Books & Records | Granted ¹²⁷ | Reduce and Reclassify in Part |
| Seventh | Duplicative Claims | Granted ¹²⁸ | Disallow and Expunge |
| Eight | Books & Records | Granted ¹²⁹ | Reduce and Allow |
| Ninth | Insufficient Support | Granted ¹³⁰ | Disallow and Expunge |
| Tenth | Duplicative Claims | Granted ¹³¹ | Disallow and Expunge |
| Eleventh | Insufficient Support | Granted ¹³² | Disallow and Expunge |
| Twelfth | Insufficient Support | Granted ¹³³ | Disallow and Expunge |
| Thirteenth | Duplicative Claims | Granted ¹³⁴ | Disallow and Expunge |
| Fourteenth | Incorrect Classification | Granted ¹³⁵ | Reclassify Claims |
| Fifteenth | Insufficient Support | Granted ¹³⁶ | Disallow and Expunge |

¹²² Order Granting Plan Administrator's First Omnibus Objection to Claims (Duplicative Claims), 07-33849-DOT, Feb. 20, 2009.

¹²³ Order Granting Plan Administrator's Second Omnibus Objection to Claims (Insufficient Documentation), 07-33849-DOT, Feb. 20, 2009.

¹²⁴ Order Granting Plan Administrator's Third Omnibus Objection to Claims (Duplicative Claims), 07-33849, Dec. 15, 2009.

¹²⁵ Order Granting Reorganized Debtors' Fourth Omnibus Objection (Claims to be Reduced and Allowed), 07-33849, Dec. 15, 2009.

¹²⁶ Order Granting Reorganized Debtors' Fifth Omnibus Objection (Insufficient Support Claims), 07-33849, Dec. 15, 2009.

¹²⁷ Order Granting Reorganized Debtors' Sixth Omnibus Objection (Claims to be Reduced, Reclassified and Allowed in Part), 07-33849, Dec. 15, 2009.

¹²⁸ Order Granting Plan Administrator's Seventh Omnibus Objection to Claims (Duplicative Claims), 07-33849, Dec. 15, 2009.

¹²⁹ Order Granting Reorganized Debtors' Eighth Omnibus Objection (Claims to be Reduced and Allowed), 07-33849, Dec. 15, 2009.

¹³⁰ Order Granting Reorganized Debtors' Ninth Omnibus Objection (Insufficient Support Claims), 07-33849, Dec. 15, 2009.

¹³¹ Order Granting Plan Administrator's Tenth Omnibus Objection to Claims (Duplicative Claims), 07-33849, Dec. 15, 2009.

¹³² Order Granting Reorganized Debtors' Eleventh Omnibus Objection (Insufficient Support Claims), 07-33849, Dec. 15, 2009.

¹³³ Order Granting Reorganized Debtors' Twelfth Omnibus Objection (Insufficient Support Claims), 07-33849, Dec. 15, 2009.

¹³⁴ Order Granting Plan Administrator's Thirteenth Omnibus Objection to Claims (Duplicative Claims), 07-33849, Dec. 15, 2009.

¹³⁵ Order Granting Reorganized Debtors' Fourteenth Omnibus Objection to Claims (Claims Asserting Incorrect Classification), 07-33849, Dec. 15, 2009.

| | | | |
|-----------------------------|------------------------------------|------------------------|-------------------------------|
| Sixteenth | Insufficient Support | Granted ¹³⁷ | Disallow and Expunge |
| Seventeenth | Incorrect Classification | Granted ¹³⁸ | Reclassify Claims |
| Eighteenth | Books and records | Granted ¹³⁹ | Reduce and Allow |
| Nineteenth | Insufficient Support | Granted ¹⁴⁰ | Disallow and Expunge |
| Twentieth | Incorrect Classification | Granted ¹⁴¹ | Reclassify Claims |
| Twenty-First | Insufficient Support | Granted ¹⁴² | Disallow and Expunge |
| Twenty-Second | Duplicative Claims | Granted ¹⁴³ | Disallow and Expunge |
| Twenty-Third | Books & Records | Granted ¹⁴⁴ | Reduce and Allow |
| Twenty-Fourth | Insufficient Support | Granted ¹⁴⁵ | Disallow and Expunge |
| Twenty-Fifth | Books & Records | Granted ¹⁴⁶ | Reduce and Reclassify in Part |
| Twenty-Sixth | Incorrect Classification | Granted ¹⁴⁷ | Reclassify Claims |
| Twenty-Seventh | Duplicative Claims | Granted ¹⁴⁸ | Disallow and Expunge |
| Twenty-Eight ¹⁴⁹ | Unsupported Attorneys' Fees Claims | Pending | |

¹³⁶ Order Granting Reorganized Debtors' Fifteenth Omnibus Objection (Insufficient Support Claims), 07-33849, Dec. 15, 2009.

¹³⁷ Order Granting Reorganized Debtors' Sixteenth Omnibus Objection (Insufficient Support Claims), 07-33849, Dec. 15, 2009.

¹³⁸ Order Granting Reorganized Debtors' Seventeenth Omnibus Objection (Claims Asserting Incorrect Classification), 07-33849, Jan. 26, 2009.

¹³⁹ Order Granting Reorganized Debtors' Eighteenth Omnibus Objection (Claims to be Reduced and Allowed), 07-33849, Jan. 26, 2009.

¹⁴⁰ Order Granting Reorganized Debtors' Nineteenth Omnibus Objection (Insufficient Support Claims), 07-33849, Feb. 2, 2009.

¹⁴¹ Order Granting Reorganized Debtors' Twentieth Omnibus Objection to Claims (Claims Asserting Incorrect Classification), 07-33849, Feb. 2, 2009.

¹⁴² Order Granting Reorganized Debtors' Twenty-First Omnibus Objection (Insufficient Support Claims), 07-33849, Feb. 2, 2009.

¹⁴³ Order Granting Plan Administrator's Twenty-Second Omnibus Objection to Claims (Duplicative Claims), 07-33849, Feb. 2, 2009.

¹⁴⁴ Order Granting Reorganized Debtors' Twenty-Third Omnibus Objection (Claims to be Reduced and Allowed), 07-33849, Feb. 2, 2009.

¹⁴⁵ Order Granting Reorganized Debtors' Twenty-Fourth Omnibus Objection (Insufficient Support Claims), 07-33849, Feb. 2, 2009.

¹⁴⁶ Order Granting Reorganized Debtors' Twenty-Fifth Omnibus Objection (Claims to be Reduced, Reclassified and Allowed in Part), 07-33849, Feb. 2, 2009.

¹⁴⁷ Order Granting Reorganized Debtors' Twenty-Sixth Omnibus Objection to Claims (Claims Asserting Incorrect Classification), 07-33849, Feb. 10, 2009.

¹⁴⁸ Order Granting Plan Administrator's Twenty-Seventh Omnibus Objection to Claims (Duplicative Claims), 07-33849, Feb. 10, 2009.

¹⁴⁹ Reorganized Debtors' Twenty-Eighth Omnibus Objection to Claims (Unsupported Attorneys' Fees Claims), 07-33849, Mar. 13, 2009.

11. The Disclosure Statement:

There are three possible ways for a Chapter Eleven proceeding to be resolved: 1) dismissal of the case; 2) conversion to another chapter proceeding; 3) confirmation of a plan of reorganization.¹⁵⁰ *In re Movie Gallery, Inc.*, the exit strategy is confirmation of a plan of reorganization.¹⁵¹ The plan of reorganization was filed on April 2, 2008, and the court confirmed the plan on April 10.¹⁵² The disclosure statement preceded the confirmation of the plan.¹⁵³ The disclosure statement is governed by 11 U.S.C. § 1125, and its approval and dissemination to creditors is a prerequisite for the debtors to solicit acceptances from the creditors.¹⁵⁴ The statute does not state exactly what is required in the disclosure statement, but the statute does say that it has to contain “adequate information” but generally the disclosure statement has to contain information about the liabilities, business affairs, assets, and any information necessary for the creditor to make an informed decision about the plan.¹⁵⁵

First, the disclosure statement in *In re Movie Gallery, Inc.*, outlined in detail the goals, risks, and procedures of the plan for reorganization for the specific case.¹⁵⁶ The projected cost recovery for each class of creditor was also included; thus, allowing the creditors to estimate the money that they would recover on the plan.¹⁵⁷ Also, the statement included general information about chapter eleven cases.¹⁵⁸ Most importantly,

¹⁵⁰ ROBERT M. LLOYD & GEORGE KUNEY, SECURED TRANSACTION: UCC ARTICLE 9 & BANKRUPTCY, 460 (2008).

¹⁵¹ Second Amended Joint Plan of Reorganization of Movie Gallery, Inc. and Its Debtor Subsidiaries Under Chapter Eleven of the Bankruptcy Code with Technical Modifications, 07-88349, (Bankr. E.D. Va. Apr. 9, 2008).

¹⁵² Findings of Fact, Conclusions of Law, and Order Confirming Second Amended Joint Plan of Reorganization of Movie Gallery, Inc. and Its Debtor Subsidiaries Under Chapter Eleven of the Bankruptcy Code with Technical Modifications, 07-88349, (Bankr. E.D. Va. Apr. 10, 2008).

¹⁵³ See generally Disclosure Statement for the Second Amended Joint Plan of Reorganization of Movie Gallery, Inc. and Its Debtor Subsidiaries Under Chapter Eleven of the Bankruptcy Code with Technical Modifications, 07-88349, (Bankr. E.D. Feb. 15, 2008).

¹⁵⁴ See, LLOYD, *supra* note 150, at 461-62; 11 U.S.C. § 1125 (2008). Specifically 11 U.S.C. 1125(a)(1) states the “adequate information” standard for the disclosure statement. However, the standard does not specify what information is necessary to satisfy “adequate information”. 11. U.S.C. § 1125 (2008). The standard is intentionally flexible to accommodate the range of bankruptcy cases.

¹⁵⁵ See, LLOYD, *supra* note 150, at 461-62; 11 U.S.C. § 1125 (2008).

¹⁵⁶ Disclosure Statement for the Second Amended Joint Plan of Reorganization of Movie Gallery, Inc. and Its Debtor Subsidiaries Under Chapter Eleven of the Bankruptcy Code with Technical Modifications, pgs. 9-32. 07-88349, (Bankr. E.D. Va. Feb. 15, 2008).

¹⁵⁷ *Id.* at 12-18.

¹⁵⁸ *Id.* at 11 .

the statement explained the voting procedures on the plan and which creditors were allowed to vote.¹⁵⁹

Second, the statement also explained the general assets, liabilities, and background of the debtor. Also explained in the statement were the reasons for the debtor’s bankruptcy. But, the most important part of the disclosure statement was the “summary of the joint plan,” which laid out in further detail some of the items discussed in the first part of the disclosure.¹⁶⁰ The summary of the joint plan discussed in detail how the plan would affect the creditors, its implementation, and how the funds would be distributed.¹⁶¹ This information is necessary so that before the creditors vote on whether to confirm the plan they have an idea of how their claim will be affected.

12. The Final Plan:

After a court approves the disclosure statement, the creditors with impaired claims vote on whether to adopt the plan.¹⁶² The votes are counted and the plan proponent asks the court to confirm the plan.¹⁶³ In the present case, the plan divided the creditors into classes and listed who was impaired.¹⁶⁴ There were twelve classes of impaired creditors.¹⁶⁵ Ten of them were eligible to vote and two others were deemed to reject the plan because they were to receive nothing under the plan.¹⁶⁶

| Class | Claim | Status | Voting Rights |
|--------------|--|---------------|----------------------|
| 1 | Other Priority Claims | Unimpaired | Deemed to Accept |
| 2 | Other Secured Claims | Unimpaired | Deemed to Accept |
| 3 | First Lien Claims | Impaired | Entitled to Vote |
| 4 | Second Lien Claims | Impaired | Entitled to Vote |
| 5 | Studio Claims | Impaired | Entitled to Vote |
| 6 | 11% Senior Note Claims | Impaired | Entitled to Vote |
| 7A | General Unsecured Claims against Movie | Impaired | Entitled to Vote |

¹⁵⁹ *Id.* at 24-30.

¹⁶⁰ *Id.* at 45-123.

¹⁶¹ *Id.*

¹⁶² *See*, LLOYD, *supra* note 150, at 461; 11 U.S.C. § 1126.

¹⁶³ *See*, LLOYD, *supra* note 150, at 461.

¹⁶⁴ Second Amended Joint Plan of Reorganization of Movie Gallery, Inc. and Its Debtor Subsidiaries Under Chapter Eleven of the Bankruptcy Code with Technical Modifications, 07-88349, pg. 18, Apr. 9, 2008. *See* 11 U.S.C. § 1124 (defining “impairment” as “unaltered the legal, equitable, and contractual” right of the creditor). A claim is impaired basically if it is changed through deceleration, cure of default, or is altered, etc . . . *See*, LLOYD, *supra* note 150, at 462-63.

¹⁶⁵ *Id.*; 11 U.S.C. § 1126(f) (presuming that class 8 & 9 will reject the plan since they will not receive anything).

¹⁶⁶ *Id.*

| | | | |
|----|---|----------|---------------------------------|
| | Gallery, Inc. | | |
| 7B | General Unsecured Claims against Movie Gallery US, LLC | Impaired | Entitled to Vote |
| 7C | General Unsecured Claims against M.G.A. Realty I, LLC | Impaired | Entitled to Vote |
| 7D | General Unsecured Claims against M.G. Digital, LLC | Impaired | Entitled to Vote |
| 7E | General Unsecured Claims and 9.625% Senior Subordinated Note Claims against Hollywood Entertainment Corporation | Impaired | Entitled to Vote |
| 7F | General Unsecured Claims against MG Automation LLC | Impaired | Entitled to Vote |
| 8 | Equity Interests in Movie Gallery, Inc. | Impaired | Entitled to Vote |
| 9 | Intercompany Interests | Impaired | Deemed to Reject ¹⁶⁷ |

i. The confirmation of the plan:

To confirm the plan, the creditors must either have consensually confirmed the plan or the court can “cramdown” the plan on the impaired creditors.¹⁶⁸ There are several requirements for the plan to be confirmed listed in section 1129(a).¹⁶⁹ For example, each holder of an impaired claim either has to approve the plan or receive the same amount under the plan that they would under a chapter seven liquidation.¹⁷⁰ In addition if there are classes of impaired claims, at least one of the classes must accept that plan.¹⁷¹ In order for the plan to be confirmed consensually at least half of the impaired creditors representing at least two thirds of the claims amount in each class have to accept the plan.¹⁷² These numbers can make it difficult to get a plan confirmed. As a result, there is the “cramdown” option. The “cramdown” is essentially an exception to the requirement

¹⁶⁷ *Id.*

¹⁶⁸ *See*, LLOYD, *supra* note 150, at 468-72.

¹⁶⁹ *See* 11 U.S.C. § 1129(a) (listing the requirements for the confirmation of the plan).

¹⁷⁰ *See* 11 U.S.C. § 1129(a)(7). Section (a)(7) provides: With respect to each impaired class of claims or interests--

(A) each holder of a claim or interest of such class--

(i) has accepted the plan; or

(ii) will receive or retain under the plan on account of such claim or interest property of a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive or retain if the debtor were liquidated under chapter 7 of this title . . . on such date.

¹⁷¹ *See* 11 U.S.C. § 1129(a)(10). Section (a)(10) provides: If a class of claims is impaired under the plan, at least one class of claims that is impaired under the plan has accepted the plan, determined without including any acceptance of the plan by any inside.

¹⁷² *See*, LLOYD, *supra* note 150, at 468-72; 11 U.S.C. § 1126(c) (stating that whole class of impaired creditors is deemed to accept the plan if the one half and two-thirds requirement is met.).

that all the classes of creditors accept the plan.¹⁷³ The “cramdown” still requires that the plan does not discriminate unfairly and is “fair and equitable.”¹⁷⁴ To meet the requirements for not discriminating unfairly, a similar claim cannot be treated drastically different than another similar claim.¹⁷⁵ Further, “fair and equitable” has a different meaning for different kinds of claims.¹⁷⁶ In the plan, the DIP asked for a “cramdown” under 11 U.S.C. 1129(b).¹⁷⁷ The request was probably a way of securing the confirmation of the plan.

The plan also discussed in detail how the debtor corporation will continue to operate as a “separate corporate entity”.¹⁷⁸ For example, the debtors will be able to create a new corporation and transfer their assets free of encumbrances to that new corporation.¹⁷⁹ After the effective date, the date the plan becomes effective, the new corporation will also be able to operate normally as a business and lease, sell, and acquire assets without the supervision of the bankruptcy court.¹⁸⁰

Also, it is very interesting that the new corporation is allowed to issue common stock that may be listed on the National Stock Exchange, but they do not have to list the stock with the Securities and Exchange Commission.¹⁸¹ Under section 1145 of the Bankruptcy Code, the usual federal and state securities laws are circumvented and any stock issued in a chapter eleven proceeding by the debtor, its affiliate, or its successor is

¹⁷³ See, LLOYD, *supra* note 150, at 468-72. The cramdown requirement is an exception to the requirement under 11 U.S.C. § 1129(a)(8) that each class accept that plan or that each class be unimpaired. See 11 U.S.C. § 1129(a)(8), (b).

¹⁷⁴ *Id.*

¹⁷⁵ *Id.*

¹⁷⁶ *Id.*

¹⁷⁷ Second Amended Joint Plan of Reorganization of Movie Gallery, Inc. and Its Debtor Subsidiaries Under Chapter Eleven of the Bankruptcy Code with Technical Modifications, 07-88349, pg. 25, Apr. 9, 2008. In the Order Confirming the Plan, the Court outlines the results of voting. Classes eight and nine were deemed to reject since they would receive no compensation. Classes 3, 4, 5, 6, 7A, 7B, 7C, 7D, 7E, 7F all voted to accept the plan. Classes 1 and 2 were deemed to accept that plan since they were not impaired. Findings of Fact, Conclusions of Law, and Order Confirming Second Amended Joint Plan of Reorganization of Movie Gallery, Inc. and Its Debtor Subsidiaries Under Chapter Eleven of the Bankruptcy Code with Technical Modifications, 07-88349, pg. 12, Apr. 10, 2008.

¹⁷⁸ Second Amended Joint Plan of Reorganization of Movie Gallery, Inc. and Its Debtor Subsidiaries Under Chapter Eleven of the Bankruptcy Code with Technical Modifications, 07-88349, pg. 25, Apr. 9, 2008.

¹⁷⁹ *Id.* Also, the plan creates a litigation trust. This is the trust that is responsible for avoiding preferences. *Id.* at 29.

¹⁸⁰ *Id.*

¹⁸¹ *Id.* at 26-7.

not registered.¹⁸² The stock must be issued “in exchange for a claim or interest in the debtor.”¹⁸³ The present case presents the scenario where stock is issued by the debtors to the creditors that may have value or prepetition equity added.¹⁸⁴

Pursuant to the Plan, 25,000,000 shares of New Common Stock were issued or reserved for issuance to certain holders of claims on the effective date.¹⁸⁵ The New Common Stock did not have to be registered on the National Stock Exchange since it was distributed pursuant to section 1145.¹⁸⁶ Moreover, the New Common Stock is freely trade-able subject to the rules and regulations of the Securities and Exchange Commission.¹⁸⁷ Overall, it is a complicated transaction allowed by the Code where the debtors issue stock to the claims holders in return for the dissolution of claims.

The “cramdown” and issuance of stock that is not governed by the Securities and Exchange Commission can be seen as another example of the power of chapter eleven. The “cramdown” is a demonstration of the court’s desire to confirm a plan and allow the company to reorganize. Section 1129(b) is a powerful tool that places reorganization of the debtors first in priority. In the present case, the debtors have reorganized into a new corporation and are wiped clean of all their encumbrances allowing them to, hopefully, succeed.

13. Outcome:

On February 5, 2008, the Bankruptcy Court approved the Disclosure Statement to the Second Amended Joint Plan of Reorganization of Movie Gallery, Inc. and its Debtor

¹⁸² George Kunej, *Going Public Via Chapter 11: 11 U.S.C. § 1125(e), 1145*, 23 CALIF. BANKR. J. 3, 6,7 (1996). Also, under 11 U.S.C. § 1145(c) stock issued under § 1145 is deemed to be a public offering. *Id.* at 7.

¹⁸³ *Id.* at 7; Section 1145(a)(1) provides:

(a) Except with respect to an entity that is an underwriter as defined in subsection (b) of this section, section 5 of the Securities Act of 1933 (15 U.S.C. 77e) and any State or local law requiring registration for offer or sale of a security or registration or licensing of an issuer of, underwriter of, or broker or dealer in, a security does not apply to--

(1) the offer or sale under a plan of a security of the debtor, of an affiliate participating in a joint plan with the debtor, or of a successor to the debtor under the plan—

(A) in exchange for a claim against, an interest in, or a claim for an administrative expense in the case concerning, the debtor or such affiliate; or

(B) principally in such exchange and partly for cash or property....

¹⁸⁴ See KUNEJ, *supra* note 182, at 4.

¹⁸⁵ Second Amended Joint Plan of Reorganization of Movie Gallery, Inc. and Its Debtor Subsidiaries Under Chapter Eleven of the Bankruptcy Code with Technical Modifications, 07-88349, pg. 25-28, (Bankr. E.D. Va. Apr. 9, 2008).

¹⁸⁶ *Id.*

¹⁸⁷ *Id.* at 28

Subsidiaries under Chapter 11 of the Bankruptcy Code (“Second Amended Plan”) and authorized Movie Gallery to solicit votes.¹⁸⁸ On April 4, 2008, Movie Gallery issued a press release stating that all the creditors entitled to vote on the Second Amended Plan voted to support the plan.

On April 10, 2008, the Bankruptcy Court entered an order (the “Confirmed Plan”) confirming the Second Amended Joint Plan. Under the agreement, Movie Gallery will emerge from bankruptcy as an independent company controlled by Sopris Capital. With the Confirmed Plan, Movie Gallery will be able to restructure the terms of its first & second lien indebtedness. Sopris will convert a total of \$72 million of its claims into equity.¹⁸⁹ Movie Gallery will also have its \$325 million 11% senior notes converted into equity.¹⁹⁰ The General Unsecured Claims will be converted into equity. Movie Gallery’s pre-petition common stock will be cancelled.

14. Conclusion:

The plan successfully consolidated MG Automation and Hollywood Entertainment into a single entity known as Hollywood Entertainment Corporation and MG Digital and Movie Gallery consolidated into Movie Gallery, USA. Further, M.G.A. Realty will be renamed MG Real Estate. As a result, the debtor ceased to exist as Movie Gallery Incorporated and was consolidated and renamed. Through Chapter 11 Bankruptcy, Movie Gallery was successfully able to shed its debt obligations that lingered from the Hollywood Video acquisition. Although Movie Gallery obtained a substantial amount of DIP financing, it was still cheaper when fees and increased interest rates are considered due to defaults on the pre-petition debt. Movie Gallery has made some changes to its business model. Powerplay is a new service that locks in prices for movies and games, and allows participants to gain “points” to be used to rent movies and games. Movie Gallery also links streamed videos of movie trailers on the website. While these changes are moves in the right direction, the innovated business model of Netflix, which utilizes both the convenience of streaming movies and no late fees, will continue to gain market share. The Chapter 11 potentially fixed the short-term liquidity problem, but a new business model is necessary for Movie Gallery to continue as a going concern. Only time will tell if Movie Gallery remains a Luddite or embraces change.

¹⁸⁸ See Finding of Fact of Fact, Conclusions of Law and Order Confirming Second Amended Joint Plan of Reorganization of Movie Gallery, Inc. and its Debtor Subsidiaries under Chapter 11 of the Bankruptcy Code with Technical Modifications, In re: Movie Gallery, INC., et al., No. 07-33849 (Bankr. E.D.V.A. Apr. 10, 2008).

¹⁸⁹ <http://www.thedeal.com/servlet/Satellite?pagename=webreprint&c=TDDArticle&cid=1207771423190>

¹⁹⁰ *Id.*