AIRA | Association of Insolvency & Restructuring Advisors

Journal

News from the Association of Insolvency & Restructuring Advisors

Volume 28, Number 1 - WInter 2014

AIRA Resident Scholar
Jack F. Williams, CIRA, CDBV
Mesirow Financial Consulting
Georgia State University

ALSO IN THIS ISSUE

The Archaeology of Professional Ethics in Bankruptcy: Part I

Let it be remembered and treasured in the heart of every student, that no person can ever be a truly great lawyer, who is not in every sense of the word, a good person. A lawyer, without the most sterling integrity, may shine for a while with meteoric splendor; but his light will soon go out in blackness of darkness. It is not in every person's power to rise to eminence by distinguished abilities. It is in every person's power, with few exceptions, to attain respectability, competence, and usefulness. The temptations which beset a young person in the outset of his professional life, especially if he is in absolute dependence upon business for his subsistence, are very great. The strictest principles of integrity and honor are his only safety. Let him begin by swerving from truth or fairness, in small particulars, he will find his character gone – whispered away, before he knows it.[1] *– George Sharswood*

What does the discipline of archaeology have to say to bankruptcy practitioners about notions of ethics and professional responsibility? Archaeology, the study of human materials of the past in an effort to understand the truths that emerge through time, provides unique perspectives on duties, relationships, contexts, and ethics. To study archaeology is to study context. Although any particular artifact may be interesting in its own right, it is that artifact's place in context (among other artifacts, things, and places) that captures the quizzical eye of an archaeologist and nurtures the wonderment standing at the heart of archaeology. The archaeologist builds a narrative from this context. The closer that narrative or theory rests on the facts, the more power and persuasiveness can be found there.

Bankruptcy and forensic accounting and restructuring advisory services are similar to the practice of archaeology. Ours is not a profession of simple debits and credits, or of simply finding the appropriate financial numbers, or of indifferently looking up values in some market index, or of casually applying off-the-shelf valuation models. It has always been something much more than that; it is an undertaking, not unlike the archaeologist's, of uncovering financial data (our profession's equivalent of artifacts), assessing the appropriate financial, economic, and accounting context, and building a narrative that strongly correlates with the financial facts in an effort to aid the ultimate user, be it the client or the trier of fact.

Archaeology is undergoing a challenging ethical controversy of late. The profession is confronting the meaning of professional responsibility within a profession that has more in common with moral philosophy than with pure science. An exciting development in this controversy has been the movement in archaeological ethics drawing from virtue theories with a focus on the importance of character, particularly when dealing with the relationship of an archaeologist to the archaeological record. Under this movement's tutelage, an archaeologist is trained to find exemplars, learning science and art at a mentor's "knee." While developing the virtues of an archaeologist, the learner is encouraged to eschew relationships with things – particularly the record – for relationships with people.

From this vantage point, bankruptcy professionalism and ethics, like their counterparts in archeology, become a study of relationships with people where virtuous character is primary and conduct is important but derivative. Relevant Bankruptcy Code sections, Bankruptcy Rules, and ethical codes become artifacts that allow us to unpack the norms and conditions of bankruptcy praxis. This article will explore a bolder view of the subject matter, drawing from the virtues (particularly the virtue of trust) in a search for what makes a virtuous bankruptcy practitioner. This is the first of two parts that will explore the topic.

***Archaeology** continues on p. 4*

[1] George Sharswood, AN ESSAY ON PROFESSIONAL ETHICS, 111-112 (T. & J.W. Johnson 1860).

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A Letter From the President

Anthony V. Sasso, CIRA
Deloitte CRG

As we close 2013 and start the New Year, I would like to recap our last big event of 2013 and provide a brief preview of VALCON 2014, as well as our Annual Conference next June.

AIRA's 12th Annual Advanced POR Conference—November 18, 2013, at the Union League Club in New York. I would like to convey special thanks to our co-chairs, Walter Greenhalgh of Duane Morris and Brian Ryniker of CBIZ MHM, for their hard work in organizing an outstanding event, and to the seven Federal Bankruptcy judges that graciously participated on the panels. We also greatly appreciated the keynote presentation by Prof. David A. Skeel Jr., S. Samuel Arsht Professor of Corporate Law, University of Pennsylvania School of Law. Dr. Skeel shared his views on "Too Big to Fail," provided an academic perspective on how the Bankruptcy Code could be modified to better serve restructuring of large financial institutions, and added context to the challenges that lie ahead in bankruptcy/restructuring of financial institutions and fully implementing Dodd Frank. At the closing reception, I had the distinct honor of presenting AIRA's 2013 Judicial Service Award to Honorable Robert E. Gerber in recognition of over 40 years' distinguished service including almost 14 years on the bench (U.S. Bankruptcy Court, S.D.N.Y.). Hon. Gerber's friend and former law clerk, Leah Eisenberg, Esq., provided heartfelt remarks that enhanced the ceremony.

VALCON 2014: Contested Valuation Issues in Bankruptcy—February 26-28 at the Four Seasons Las Vegas, co-hosted by AIRA, The University of Texas Law School and ABI. Beat the winter blues, book your tickets to Las Vegas today, and have an opportunity to earn up to 17 CPE/14.25 CLE, including 1 hour of Ethics. For details on all of these events and others, see www.AIRA.org.

AIRA's 30th Annual Bankruptcy and Restructuring Conference—As planning continues for our 2014 Annual Conference at the Westin Denver Downtown, please remember to save the dates June 4-7, 2014. The conference is shaping up to be another great event, with sessions covering the future of bankruptcy and restructuring, negotiation of complex bankruptcy plans, business valuation and methodologies, social media, ESI, and much more. Excursions and social activities will offer tours of the Denver Mint and Red Rocks Amphitheatre, golf outing, MLB baseball, hiking and/or river rafting, and a brewery tour (more details in the next issue).

I wish everyone the best in 2014, and hope to see you in Vegas or Denver, or both!

Tony Sasso

Article 9 Amendments, Again, Already!

How the 2013 Changes Will Affect Insolvency and Restructuring Advisors

Part Two: More, Not-So-Basic Rules[1]

Lawrence R. Ahern III
Brown & Ahern

INTRODUCTION

Scope

Part One of this article[2] discussed the basic changes in Article 9 of the Uniform Commercial Code (UCC) in 2013,[3] which attempted to clarify the standards for measuring whether a financing statement sufficiently lists the name of the debtor. The primary purpose of those changes was to make it easier for security interests to be perfected by filing. At the same time, the new legal standards, coupled with strict search logic standards being adopted by filing offices, should also make it easier for debtors, trustees and their advisors to identify potential challenges to the perfection of a security interest that does not comply with the revised rules.

This second part of the series will explore some of the other changes in Article 9, generally effective July 1, 2013, such as the rules related to trusts and trustees in bankruptcy, the location of the debtor and filings that are made prior to closing. This still does not aspire to be a complete analysis of all the 2013 amendments. For example, it will exclude some issues of importance primarily to creditors in intramural priority disputes. Instead, it will focus on issues of greatest interest to insolvency and restructuring advisors. In several instances, these simplify the task of evaluating secured claims and highlight problems that all parties to the bankruptcy process should anticipate.

Interplay of Article 9 and the Bankruptcy Code

As explained in the first part of this article, section 544(a)(1) of the Bankruptcy Code[4] provides "strong arm" powers to the trustee in bankruptcy and debtor in possession (DIP) in Chapter 11,[5] with those fiduciaries having the status of a hypothetical judicial lien creditor, as of the commencement of the bankruptcy case. This status allows the estate to "avoid" any Article 9 security interest that is subordinate to such a creditor. Exercising these powers together with the priority rules in Article 9,[6] the trustee or DIP can avoid a security interest that had not become perfected before the filing of the petition commencing the bankruptcy case.[7] In addition, delayed perfection of a security interest within the 90-day or one-year period prior to filing may expose the creditor to avoidance of its security interest as a preferential transfer under section 547, because the preference rules tie the date of the "transfer" to the date of perfection.[8] Because most security interests are perfected by filing a financing statement, establishing compliance with the filing rules is usually the first step in determining whether a security interest can be attacked in bankruptcy.

Location of the Debtor

The Article 9 choice-of-law rules determine, among other things, where to file a financing statement. These rules are not changing in 2013, but the 2013 amendments may sometimes affect the location of the debtor, so the consequences of a change in location are important to review.

Article 9 contains a fundamental feature that is different from the version of Article 9 that existed until 2001. The basic pre-2001 rule chose the law of the state in which the collateral was found -- the location of the collateral -- as the law that governed perfection. That made sense in the mid-Twentieth Century world that had focused on real estate, which tends to stay put. Since 2001, however, the rules generally choose the jurisdiction that is the location of the debtor. Thus, if the debtor is an entity created by registration in a state, if it is has an organizational "birth certificate" on file,[9] then the location of the debtor is the location in which it is registered.[10] If the organization is not registered, its location is determined by its place of business[11] or, if it has more

Amendments *continues on p. 11*

[1] Portions of this article were adapted from *Article 9 Amendments, Again, Already? How the 2013 Changes will Affect Trustees*, by Lawrence R. Ahern, III, which first appeared in NABTalk, the Journal of the National Association of Bankruptcy Trustees, Spring 2013, Volume 29, Issue 1, pps. 20-31 & 64. Adapted by permission of NABT. Other portions were adapted from works published by Thomson Reuters (West Publishing), and are used here with permission. For more information about these publications, go to <http://west.thomson.com/store/> and <www.nabt.com>. ©2013. All rights reserved. Further duplication or distribution prohibited without permission. Reprint requests may be directed to Lawrence R. Ahern, III, LAhern@BrownAhern.Com, <www.BrownAhern.com>.

[2] Ahern, *Article 9 Amendments, Again, Already! How the 2013 Changes Will Affect Insolvency and Restructuring Advisors, Part I: The Debtor's Name*, 27 No. 1 AIRA J. 1 (May-June 2013).

[3] Extensive revisions of Article 9, proposed in 1998, were adopted almost universally with a uniform effective date of July 1, 2001, and may be referred to as the "2001 revision." The amendments adopted in 2010, with a uniform effective date of July 1, 2013, have now been adopted by most jurisdictions and will similarly be referred to as the "2013 amendments." Where the partially-revised portions of the 2013 amendments are quoted in the text and in these footnotes, deletions from the pre-2013 version are ~~stricken through~~. Unless it is clear that some text is entirely new, additions are shown by *italics*.

[4] 11 U.S.C. § 544(a)(1).

[5] Unless and until a trustee is appointed, the debtor in possession is vested with all of the powers of a trustee that are relevant to this discussion. 11 U.S.C. § 1107(a).

[6] See, e.g., UCC § 9-102(a)(52)(C) (defining "lien creditor" to include trustees in bankruptcy).

[7] See UCC UCC § 9-317(a)(2).

[8] 11 U.S.C. § 547(e)(1)(B). As explained in Part I, only when the secured creditor can survive the attack of the hypothetical judgment lien creditor has the creditor received the potentially preferential "transfer." Thus, for example, if a loan is initially secured by an unperfected security interest (perhaps because the filing is defective) and the security interest is perfected later and within 90 days prior to bankruptcy, it may be vulnerable to avoidance as a preference.

[9] UCC § 9-102(a)*(71)*.

[10] UCC § 9-307(e).

[11] UCC § 9-307(b)(2).

Archaeology continued from pg. 1

Codes and Rules

Bankruptcy practitioners operate in a sea of codes. They must comply with the Bankruptcy Code, Bankruptcy Rules, and potential multiple ethical codes. For the purposes of this article, ABA Model Rules and the AIRA/CIRA Code of Conduct will be used as examples. But the reader is asked to consider a few questions: Have you as a bankruptcy practitioner ever stepped back and attempted to gain perspective on what such codes and rules seek to accomplish, what ethical role do you actually play, or what does it mean to be a fiduciary to the estate? Or do you, like me, often find yourselves going at full speed just trying to keep up with the demands of the practice and the times? Let us take this opportunity to step back, gain perspective, and ponder a few of those questions. If I can raise your awareness, if I can foster either an internal or external discussion, I shall consider it a modest achievement. I shall also be delighted if you reach out to me with any thoughts or suggestions you may have. This is, by no means, the last word on the subject of professional responsibility.

Nature of Codes

For the practicing bankruptcy attorney, there is no lack of regulatory codes or guidance on professional ethics. In fact, as a profession, we are privy to an overabundance of ethical codes. We have the Bankruptcy Code, the Bankruptcy Rules, the ABA Model Rules, our individual state's code of conduct, the AICPA rules for CPAs, the AIRA rules for CIRAs and CDBVs, and the list can go on and on. But what are codes of ethics? Are they good for a profession? Necessary for a profession? How do they make us better at what we do as bankruptcy professionals?

Initially, I ask that you think of the ethical codes that attempt to regulate your professional life as artifacts, in many ways no different than stone tools or lithics, projectile points, pottery shards, baskets, etc. They are the fruits of the labor and imagination of human hands. Professors Clarie Smith and Heather Burke observe that codes provide context for ethical dilemmas facing any profession at the time of their enactment. Such codes express the "common core of group wisdom."[2] A code "distills the belief of its members, articulates the underlying assumptions and guiding principles of the association, and provides a fundamental framework for conducting research in an ethical and responsible way."[3] Each code is developed in a "social 'bubble,' resulting in widely differing core values."[4] Thus, codes are developed from the needs of a particular group at a particular time and place, to deal with local situations in different parts of the world.[5]

Professors Smith and Burke also observe that professional codes capture a professional spirit, the most important attribute of a code, from their perspective.[6] It is this spirit that serves the professional in working through ethical problems and dilemmas.[7] However, Smith and Burke cogently propose that the very existence of a code of ethics may present dangers to a profession.[8] Among these dangers is the suggestion that codes are closed systems with answers to most ethical questions and dilemmas embedded within.[9] Moreover, the existence of a code suggests to some that what is not specifically prohibited is permitted.[10] Finally, codes are products of their time and, thus, are always in a state of flux;[11] codes of ethics appear to be relatively poor time travelers.

Present ethical code systems generally come in three varieties: (1) rule-based systems; (2) standard-based systems; and (3) hybrid-based systems.[12] Rule-based systems contain specific directives in an attempt to provide clear guidance to a professional; for example, regarding what conduct is permitted or prohibited.[13] Rules are designed, by nature, to limit discretion of the professional whose conduct they seek to regulate.[14]

The deficiency in a rule-based approach is that any code is inherently both over– and under-inclusive.[15] That is, there will be some types of conduct that are prohibited by a rule-based code that should otherwise be permitted in a particular circumstance, some types of conduct that will be permitted that should be prohibited in a particular circumstance, and some types of conduct that were never contemplated by the drafters of the code.[16] Within a professional ethic, codes tend to foster absolutism in an environment where one can ill-afford a congregation of one-eyed prophets.

Standard-based systems attempt to address both the over– and under– inclusiveness of a rule-based approach by permitting a freer exercise of discretion by a professional whose conduct these systems seek to regulate.[17] In contrast to specific rule directives, standard-based systems contain ethical principles, often couched within an aspirational patina, that establish fundamental tenets.[18]

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2 Clarie Smith and Heather Burke, In the Spirit of the Code, in ETHICAL ISSUES IN ARCHAEOLOGY, 178 (L.K. Zimmerman, K.D. Vitelli & J. J. Hollowell-Zimmer eds. 2003).
3 *Id.*
4 *Id.*
5 *Id.* at 191.

6 *Id.* at 179.
7 *Id.*
8 *Id.* at 191.
9 Chip Colwell-Chanthaphonh and T.J. Ferguson, *Trust and Archaeological Practice: Towards a Framework of Virtue Ethics* in The Ethics of Archaeology: Philosophical Perspectives on Archaeological Practice, 116 (C. Scarre & G. Scarre eds. 2006).
10 Smith and Burke at 191.
11 *Id.*
12 Kathleen M. Sullivan, The Supreme Court 1991 Term – Foreword: The Justices of Rules and Standards, 106 Harv. L. Rev. 22, 57-61 (1992); Louis Kaplow, Rules Versus Standards: An Economic Analysis, 42 Duke L.J. 557 (1992); Colin S. Diver, The Optimal Precision of Administrative Rules, 93 Yale L. J. 65 (1983).
13 Sullivan at 58; Jack F. Williams, *Process and Prediction: A Return to a Fuzzy Model of Pretrial Detention*, 79 Minn. L. Rev. 325, 360-362 (1994).
14 Sullivan at 58; Williams, *Process and Prediction* at 360-362.
15 *Id.*
16 Colwell-Chanthaphonh and Ferguson, 116; *see also* Sullivan 1992; Williams, *Process and Prediction* at 360-362.
17 Sullivan 58-59; Williams, *Process and Prediction* 360-362.
18 *Id.*

Although a standard-based system allows a professional broader discretion to manage the errors of over– and under–inclusiveness, the system introduces a new set of errors. These errors include the biases (including conflicts of interest) and prejudice (including both cognitive and noncognitive varieties) of the professional in reaching a decision on what is or is not prohibited; incompetence of the professional, which is effectively masked under a standard-based system; lack of guidance on confronting the most difficult ethical dilemmas; and the absence of opportunity for meaningful review of alleged actions of misconduct.[19]

Hybrid-based systems attempt to amalgamate rule-based and standard-based approaches in a theoretical effort to reduce the types of errors endemic to each of the classical approaches. However, instead of fixing the problems of error delineated above, hybrid systems often carry with them a combination of errors found in the systems from which they are created.

Contemporary ethical paradigms are steeped in aspirational ethical principles with their concomitant range of errors and deficiencies, and/or code directives with their own stable of errors and deficiencies. The hybrid-based systems splice conflicting rules of conduct and ethical principles together and suggest, if not demand, a form of intellectual balancing of competing ethical concerns with no meaningful guidance as to what to consider in the balance, what weight should be accorded each concern, or how ultimately to strike a balance in the final instance. Strikingly, any present ethical system contains within it an interesting irony. The flavor of the ethical system ultimately embraced is itself driven, in large part, by a question of trust. In a rule-based ethical system, the super-authority distrusts the professional and limits her or his discretion through a matrix of specific directives.[20] In a standard-based ethical system, the super-authority generally trusts the professional and expands her or his discretion, but with little guidance in addressing the difficult questions and dilemmas that will be confronted.[21]

In summary, codes of ethics bring with them advantages and disadvantages. The advantages are largely process-based; that is, the codes focus debate and discussion on the issues of importance to the profession at the time. The disadvantages are found in the actual structure of the codes. Rule-based codes are over- and under-inclusive. Standard-based codes correct for these types of error but introduce bias, prejudice, and incompetence. Both forms of codes do carry with them an overarching disadvantage: they end thought and suggest that answers to ethical questions are found largely within their four corners.

19 *Id.*

20 Jack F. Williams, *Distrust: The Rhetoric and Reality of Means-Testing*, 7 Am. Bankr. Inst. L. Rev. 105, 121-122 (1999).

21 *Id.*

Some Ethical Code Provisions to Keep in Mind

The ABA Model Rules of Professional Conduct (or state law equivalent) establishes rules of conduct obligatory for every attorney when carrying out attorney activities. These rules of conduct are founded on moral criteria, advocacy traditions, and standards of the legal profession. Following is a smattering of rules to keep in mind (http://www.abanet.org/cpr/mrpc/mrpc_toc.html):

- Rule 1.2 – The Scope of Representation and Allocation of Authority: (a) "A lawyer shall abide by a client's decisions concerning the objectives of representation and, as required by Rule 1.4, shall consult with the client as to the means by which they are to be pursued."
- Rule 1.3 – Diligence: "A lawyer shall act with reasonable diligence and promptness in representing a client."
- Rule 1.4 – Communications: (b) "A lawyer shall explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation."
- Rule 1.6 – Confidentiality of Information: (a) "A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is permitted by [other provisions of the rules]. . . . "
- Rule 1.7 – Conflict of Interest: Current Clients: "(a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest . . . ."
- Rule 1.8 – Conflict Of Interest: Current Clients: Specific Rules: "(b) A lawyer shall not use information relating to representation of a client to the disadvantage of the client unless the client gives informed consent, except as permitted or required by these Rules . . . ."
- Rule 1.13 – Organization As Client: "(a) A lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents. . . ."
- Rule 2.1 – Advisor: "In rendering advice, a lawyer may refer not only to law but to other considerations such as moral, economic, social and political factors, that may be relevant to the client's situation."
- Rule 2.3 – Evaluation For Use By Third Persons: "(a) A lawyer may provide an evaluation of a matter affecting a client for the use of someone other than the client if the lawyer reasonably believes that making the evaluation is compatible with other aspects of the lawyer's relationship with the client [and] (b) When the lawyer knows or reasonably should know that the evaluation is likely to affect the client's interests materially and adversely, the lawyer shall not provide the evaluation unless the client gives informed consent. . . ."
- Rule 3.1 – Meritorious Claims And Contentions: A lawyer shall not bring or defend a proceeding, or assert or controvert an issue therein, unless there is basis in law and fact for doing so that is not frivolous, which includes good faith argument for extension, modification or reversal of existing law. A

lawyer for the defendant in a criminal proceeding, or the respondent in a proceeding that could result in incarceration, may nevertheless so defend the proceeding as to require that every element of the case be established.

- Rule 3.2 – Expediting Litigation: "A lawyer shall make reasonable efforts to expedite litigation consistent with the interests of the client."
- Rule 3.3 – Candor Toward the Tribunal: A lawyer should not make a false statement of fact or law, fail to disclose directly adverse legal authority in the controlling jurisdiction, offer knowingly false evidence to a tribunal. In an "ex parte proceeding, a lawyer shall inform the tribunal of all material facts known to the lawyer that will enable the tribunal to make an informed decision, whether or not the facts are adverse."
- Rule 3.4 – Fairness to Opposing Party and Counsel: A lawyer should not obstruct another party's access to evidence, falsify evidence, disobey an order of a tribunal, or make frivolous discovery requests.

The Association of Insolvency & Restructuring Advisors maintains a Code of Professional and Ethical Conduct for CIRAs and other members, found at https://www.aira.org//aira/ethics. The Code includes five overarching standards—competence, confidentiality, integrity, objectivity, and due care—with multiple rules and standards within each one. These standards focus on due care, loyalty, honesty, and impartiality. It is worthwhile to reflect on the reasons why so many of the ABA Model Rules discussed above shed light on the same underlying principles as the CIRA standards, even though they seek to regulate two different professions.

Professor Jack F. Williams, PhD, JD, CIRA, CDBV*, is Senior Managing Director with Mesirow Financial Consulting, LLC, and Professor of Law at Georgia State University College of Law/Middle East Institute in Atlanta, Georgia, where he teaches and conducts research in a number of areas, including Bankruptcy, Business and Commercial Law, Finance and Capital Markets, Tax, and Archaeology (Ancient Exchanges, Markets, and Commerce).*

Plan Support Agreements: Lessons from the Innkeepers and Indianapolis Downs Decisions

Michael R. Lastowski
Duane Morris LLP

Plan support agreements ("PSAs") have become an increasingly popular mechanism for galvanizing consensus and reducing costs in chapter 11 cases. The debtor and one or more constituents enter into a PSA in order to bind those constituents to vote in favor of a plan of reorganization. A plan term sheet or draft plan is often an exhibit in the PSA. The non-debtor parties usually agree to specific performance of their obligations. On the other hand, the debtor (or an official committee of unsecured creditors) usually maintains a "fiduciary out," in the event of a material change of circumstances.

The filing of a prepetition PSA announces to vendors and creditors that the debtors are on the path to a quick emergence from chapter 11 through an accelerated confirmation of a "pre-arranged plan." A post-petition agreement locks up major constituents and avoids potential contested matters and related delay. In either case, the agreement creates momentum towards confirmation.

Two bankruptcy court decisions, *In re Innkeepers USA Trust, et al.*, 442 B.R. 227 (Bankr. S.D. N.Y. 2010) and *In re Indianapolis Downs, LLC*, 486 B.R. 286 (Bankr. D. Del. 2013) illustrate potential pitfalls in enforcing PSAs as well as strategies to increase the likelihood of enforcement.[1]

Innkeepers

In *Innkeepers*, the debtors had negotiated a PSA with a secured creditor ("Lehman"). Judge Shelley C. Chapman denied the debtors' motion to assume the agreement. Under the facts of that case, her decision was not surprising. For example, the proposed plan issued all of the outstanding new shares of common stock of the debtors to Lehman, even though Lehman was a secured lender to only 20 of 92 debtors. An insider of the debtors was a beneficiary of the agreement. Further, the debtors did not conduct a marketing process; in fact, they advised their investment bankers not to pursue other transactions. The debtors' "fiduciary out" only permitted the debtors to pursue an alternate transaction which provided increased benefits to Lehman. The debtors failed to convince Judge Chapman that they had exercised "due care" in entering into the agreement. The debtors had not engaged in an "even handed" approach towards their creditors. Almost all creditors, except for Lehman, were excluded from the process. The debtors had secured DIP financing and their hotels were performing well. There were no compelling business reasons to justify the hasty confirmation of a lopsided plan. By denying the motion, Judge Chapman had given the debtors a "wide berth to fulfill their fiduciary duties to conduct a plan process which maximizes the value for all of the estates and treats the various tranches of debt with greater neutrality." Ultimately, the debtors confirmed a plan which was materially different from the plan proposed by the PSA.

Indianapolis Downs

In *Indianapolis Downs*, Judge Shannon, facing very different facts, approved a PSA. In that case, the debtors and other stakeholders entered into a PSA post-petition, prior to the approval of a disclosure statement. Several creditors argued that the agreement was evidence of improper solicitation of acceptances of a plan in violation of 11 U.S.C. § 1125(b), which generally prohibits such solicitation in the absence of an approved disclosure statement. Those creditors moved the court to designate (*i.e.*, disqualify) the votes of the parties to the PSA as not having been solicited in "good faith." Judge Shannon denied the motion.

As Judge Shannon observed, "the seminal case in [the Third] Circuit construing solicitation and designation of votes is *In re Century Glove*, 860 F.2d 94 (3d Cir. 1988)." In *Century Glove*, the Third Circuit held that the term "solicitation," within the meaning of 11 U.S.C. § 1125, should be construed narrowly, since an expansive reading would inhibit creditor-debtor negotiations. In *Indianapolis Downs*, Judge Shannon observed that the parties to the PSA were "sophisticated financial players" represented by "able and experienced professionals." Importantly, the PSA excused the non-debtor parties' performance in the event that an approved disclosure statement included facts materially different from the facts available to those parties when they entered into the PSA. The Court ultimately held that "when a deal is negotiated in good faith between a debtor and sophisticated parties, and that arrangement is memorialized in a written commitment and promptly disclosed, § 1126 will not automatically require designation of the votes of the participants." Judge Shannon denied the motion to designate.

Notably, Judge Shannon was not persuaded by the objecting creditors' citation to two earlier District of Delaware decisions

[1] The *Indianapolis Downs* decision was discussed briefly by Grant Newton in *AIRA Journal*, Volume 26, No. 5 – (2013), p. 3

which held, under the unique facts of those cases, that post-petition PSA's violate 11 U.S.C. § 1125(b).[1] The *Indianapolis Downs* decision joins other opinions in other districts which have upheld post-petition PSAs which precede the court's approval of a disclosure statement.[2]

Strategies for Implementation of a PSA

A debtor must be prepared to prove the exercise of due care in entering into a PSA. There must be evidence that the debtor investigated other available alternatives and that negotiations were at arm's length. The terms of a plan which appears to be unreasonably crafted for the benefit of one creditor will undermine a debtor's efforts to prove due care.

Further, the debtor must demonstrate transparency; in *Innkeepers*, the lack of transparency "spurred extensive discovery requests and a motion for an examiner." Finally, the agreement should include a true "fiduciary out," which excuses the debtor from performance in the event of changed circumstances, including higher and better offers or improved business conditions.

In *Indianapolis Downs*, a key to successful enforcement of the PSA was also transparency. The debtors filed the PSA simultaneously with a plan and disclosure statement. The disclosure statement described the PSA at length and the debtor was not bound to the terms of the PSA until approval of the disclosure statement. The disclosure of new and materially different facts in an approved disclosure statement excused the non-debtors' performance. The non-debtor parties to the agreement were informed and experienced. Under these circumstances, a court is likely to conclude that non-debtor parties do not need the benefit of an approved disclosure statement to enter the agreement.

The PSA should provide that, to the extent that any signatories transfer their claims, any transferees are bound by the provisions of the PSA.

Finally, the debtor and a statutory committee must have a "fiduciary out" at least until the court's approval of a disclosure statement.

__Michael R. Lastowski__ is the managing partner of the Wilmington office of Duane Morris LLP. Mr. Lastowski practices in the areas of bankruptcy law and commercial litigation. Admitted to practice in Delaware and Pennsylvania, Mr. Lastowski's practice is comprised primarily of representing debtors, creditors' committees and asset purchasers in chapter 11 proceedings. He is certified by the American Board of Certification in business bankruptcy and is a member of the Board of Directors of the AIRA. He has been listed in multiple editions of Chambers USA: America's Leading Business Lawyers.

[1] *See* Transcript of Omnibus Hearing, *In re Stations Holding Co., Inc.*, Case No. 02-10882 (Bankr. D. Del. Sept. 25, 2002); Transcript of Hearing, *In re NII Holdings, Inc.*, Case No. 02-11505 (Bankr. D. Del. Oct. 22, 2002); *but see* Transcript of Hearing, *In re Owens Corning*, Case No. 00-3837 (Bankr. D. Del. June 23, 2006).

[2] *See e.g.*, *Official Comm. Of Unsecured Creditors of New World Pasta Co. v. New World Pasta Co.*, 322 B.R. 560 (M.D. Pa. 2005); *In re Kellogg Partnership*, 160 B.R. 336 (Bankr. D. Minn. 1993); *In re Texaco, Inc.*, 81 B.R. 813 (Bankr. S.D. N.Y. 1988).

4th Circuit Upholds Extension of Protections to Intellectual Property Licensees in Ch. 15 Case

Alan R. Lepene, William H. Schrag, Andrew L. Turscak, Jr., Curtis L. Tuggle and Jim Henderson

Thompson Hine LLP

The United States Court of Appeals for the Fourth Circuit recently affirmed the bankruptcy court decision in the *Qimonda AG* chapter 15 bankruptcy case,[1] providing that holders of intellectual property licenses based on U.S. patents are entitled to the special protections contained in 11 U.S.C. § 365(n).[2] In so doing, the court bolstered the rights of U.S. intellectual property licensees whose agreements might otherwise be vulnerable to termination in a cross-border insolvency proceeding.

Background

Qimonda AG (Debtor), a German manufacturer of semiconductors, filed an insolvency proceeding in Munich, Germany in January 2009. The German court appointed Dr. Michael Jaffé (Administrator) to serve as the Debtor's insolvency administrator and to wind up the Debtor's affairs and sell its assets. The Debtor's most valuable assets were its roughly 10,000 patents, about 4,000 of which were issued in the United States.

As a significant portion of the Debtor's assets consisted of U.S. patents, the Administrator filed an application in the U.S. Bankruptcy Court for the Eastern District of Virginia (Bankruptcy Court) requesting recognition of the German insolvency proceeding and various forms of relief under chapter 15 of the Bankruptcy Code. The Bankruptcy Court approved the application, entering an order naming the Administrator as the exclusive representative of Qimonda AG in the United States and providing that several sections of the Bankruptcy Code would apply to the U.S. ancillary proceeding, including § 365.

The Debtor, like most other companies in the semiconductor business, was party to numerous cross-license agreements allowing designated entities to use its patents. Shortly after filing the chapter 15 petition, the Administrator sent notices to the entities that had entered into license agreements with the Debtor relating to its U.S. patents, informing them that he was terminating the license agreements pursuant to § 103 of the German Insolvency Code.[3] A number of U.S. licensees protested, asserting that under § 365(n) of the Bankruptcy Code, the Administrator could not terminate the licenses, and several licensees (Objecting Licensees) filed a formal objection with the Bankruptcy Court.

The Bankruptcy Court's Decision

Relying on two sections of chapter 15 of the U.S. Bankruptcy Code, the Bankruptcy Court ruled that the Objecting Licensees were entitled to the protections of § 365(n) with respect to the Debtor's U.S. patents.

The Bankruptcy Court first looked to § 1522(a)[4] and concluded that it was required to balance the Debtor's interests against the Objecting Licensees' interests to determine whether § 365(n) should be made applicable to the administration of the Debtor's chapter 15 case. After weighing the potential harm to both sides, the court was persuaded that if it did not require the Administrator to abide by § 365(n), it would create a "very real" risk to the substantial investment the licensees had collectively made in research and manufacturing facilities in the United States, an investment primarily made in reliance on the design freedom provided by the cross-license agreements.[5] While the Bankruptcy Court acknowledged the Debtor's estate would realize a higher recovery if the Administrator were able to terminate the license agreements, the court was not persuaded this interest outweighed the damages the Objecting Licensees would incur if § 365(n) were held not to apply.

As a separate rationale for its holding, the Bankruptcy Court determined that the relief sought by the Administrator would violate § 1506 of the Bankruptcy Code, which allows a court to refuse to apply a foreign jurisdiction's law if application of that law "would be manifestly contrary to the public policy of the United States."[6] The court, noting that Congress created § 365(n) to protect "American technological development" and promote innovation, concluded it would be contrary to American public policy to deny the Objecting Licensees these protections.[7]

The Fourth Circuit's Decision

The Administrator appealed and asked the district court to certify a direct appeal to the Fourth Circuit. The district court agreed these issues were appropriate for a direct appeal; the Fourth Circuit concurred and authorized the direct appeal.[8]

The Administrator made three arguments to the Fourth Circuit in support of his contention that the Bankruptcy Court erred in holding that under § 1522(a) he had to abide by § 365(n) with respect to licenses relating to the Debtor's U.S. patents. Specifically, he argued that the Bankruptcy Court erred in even considering §

1 See *Jaffé v. Samsung Electronics Co. Ltd.*, 2013 U.S. App. LEXIS 24041 (4th Cir. Dec. 3, 2013).

2 Section 365(n) grants intellectual property licensees special protections, including restrictions upon a debtor's ability to unilaterally terminate intellectual property license agreements. See 11 U.S.C. § 365(n).

3 *Id.* at *12. As the Fourth Circuit explained, § 103 of the German Insolvency Code is similar to Bankruptcy Code § 365, in that it allows an insolvency administrator to decide whether a debtor will continue to perform under its executory contracts. However, § 103 does not provide a German intellectual property licensee with the same protections afforded to a U.S. intellectual property licensee under § 365(n).

4 Under § 1522(a) a court may grant the type of relief a debtor requests only "if the interests of the creditors and other interested entities, including the debtor, are sufficiently protected." 11 U.S.C. § 1522(a).

5 *Jaffe*, 2013 U.S. App. LEXIS 24041 at *20.

6 11 U.S.C. § 1506.

7 *Jaffe*, 2013 U.S. App. LEXIS 24041 at *21.

8 *Id.* at *22.

1522(a) since that section only applies to relief requested by the foreign administrator and he had never requested relief under § 365(n).[9] Also, he asserted the Bankruptcy Court utilized the wrong test when it balanced the Debtor's interests against those of the Objecting Licensees. Finally, the Administrator argued that the Bankruptcy Court overestimated the risk of harm to the Objecting Licensees.

The Fourth Circuit was not persuaded by the Administrator's arguments. The court disagreed that the Bankruptcy Court erred in considering § 1522(a) and stated that the Administrator's interpretation of that section was too narrow. Additionally, while acknowledging the Administrator's interpretation of the balancing test contained in § 1522(a) was plausible, the court held that the test employed by the lower court was more logical and better captured the intent of Congress and the drafters of the United Nations Commission on International Trade Law (UNCITRAL) Model Law on Cross-Border Insolvency.[10] Finally, the Fourth Circuit determined that the Bankruptcy Court reasonably weighed both the Debtor's and the Objecting Licensees' interests and thus refused to overturn the Bankruptcy Court's decision to extend the protections contained in § 365(n) to the holders of license agreements involving the Debtor's U.S. patents.

Since the Fourth Circuit affirmed the Bankruptcy Court's holding on the grounds that it correctly interpreted § 1522(a), the Fourth Circuit did not directly address the Bankruptcy Court's alternative rationale that denying the Objecting Licensees the protections contained in § 365(n) would be manifestly contrary to U.S. public policy. However, in the last section of the opinion the court intimated it agreed with the Bankruptcy Court's conclusion on this point.[11]

Future Implications for Licensees

The Fourth Circuit decision will have a significant impact on chapter 15 cases in which the debtor's estate includes U.S. patents subject to cross-license agreements. The decision will undoubtedly strengthen the position of intellectual property licensees in their negotiations with the debtor. The case also stands as strong authority for the proposition that the interests of U.S. creditors must be "sufficiently protected," which is an easier standard to satisfy than establishing that another country's law is "manifestly contrary" to U.S. public policy.

There are, however, several important limitations and unanswered questions from the *Qimonda* case. First, both the Bankruptcy Court and the Fourth Circuit were careful to limit their holdings to the territorial jurisdiction of the United States.

Second, since the Fourth Circuit did not reach a decision on the public policy question, a debtor may still be able to prevail if it can convince a court that the facts in its case should lead to a different result under § 1522(a). Thus, both debtors and intellectual property licensees should be prepared to present evidence demonstrating their respective interests are entitled to greater weight in the § 1522(a) analysis. However, this argument could become moot if courts conclude that disregarding an objecting licensee's § 365(n) rights is manifestly contrary to U.S. public policy and thus cannot be enforced under § 1506.

Finally, it is unclear whether other circuits will follow the Fourth Circuit's decision.[12] It is worth noting the United States appeared as *amicus curiae*, arguing the Bankruptcy Court overstepped its authority.[13] While the Fourth Circuit disagreed, other jurisdictions could reach a different conclusion.

Important questions remain, but the Fourth Circuit's decision represents a significant victory for parties with intellectual property licenses based on U.S. patents.

For more information on these and other cross-border insolvency, intellectual property, and restructuring and bankruptcy issues, please contact:

Alan R. Lepene — Alan.Lepene@ThompsonHine.com

William H. Schrag —William.Schrag@ThompsonHine.com

Curtis L. Tuggle — Curtis.Tuggle@ThompsonHine.com

Andrew L. Turscak, Jr. — Andrew.Turscak@ThompsonHine.com

Jim Henderson — James.Henderson@ThompsonHine.com

This article originally appeared in a December 2013 advisory bulletin of Thompson Hine LLP. Its publication is not intended as legal advice and readers should not act upon the information contained in it without professional counsel.

9 *Id*. at *28. However, it is interesting to note that at the outset of the chapter 15 case, the Administrator sought a supplemental order making Code § 365 applicable, which the Administrator subsequently moved to delete in its entirety. *Id*. at *11-12.

10 *Id*. at *35-36. As noted by the Fourth Circuit, chapter 15 is based on the UNCITRAL Model Law on Cross-Border Insolvency.

11 *Id*. at *48-51. Judge Wynn, in a short concurrence, refused to join this section of the opinion because he felt the discussion was "unnecessary dictum."

12 The Fourth Circuit stated that it was joining the Fifth Circuit, which one year earlier had similarly interpreted § 1522(a). See *In re Vitro S.A.B. de C.V.*, 701 F.3d 1031 (5th Cir. 2012).

13 *Id*. at *29-30 n. 3. Specifically, the United States was concerned that the Bankruptcy Court was attempting to "superimpose Section 365(n) on the operation of German insolvency law in a German proceeding." However, the Fourth Circuit took the view that the Bankruptcy Court's holding was limited to patents issued by the United States and to the territorial jurisdiction of the United States.

Amendments continued from pg. 3

than one, its chief executive office.[12] An individual is located in the state of his or her principal residence.[13]

TRUSTS CLARIFIED?

When collateral is held in trust, the rules for naming the debtor fall into two categories. First, in the case of a trust that is a registered organization—a trust that is officially registered under the laws of the state—the name of the debtor on the UCC-1 should be the name on the public organic record[14] of the trust. For other trusts (those that are not registered organizations), the name of the debtor should be the name of the trust itself; if the trust has no name, the name of the settlor or testator should be used. If using the trust's name, the filer should indicate in a special part of the financing statement that the collateral is held in trust. If using the settlor's or testator's name, the financing statement should provide sufficient additional information to distinguish the debtor trust from other trusts with the same settlor or testator.

One focus of these rules is the "Massachusetts business trust." The 2013 amendments have attempted to make it clear that Massachusetts business trusts are registered organizations, with the effect that a filing should be under the registered organization name. As explained in the first part of this article, that is the name that is submitted to the Secretary of State or Commonwealth. This may or may not be effective to establish that a Massachusetts business is actually a registered organization. The continuing problem is that, outside commercial law, courts (including Massachusetts courts) differ over whether a business trust is a distinct legal entity.[15]

Thus, with regard to collateral that is held in trust, the debtor's name on the financing statement depends in part on whether the trust is a registered organization. If the trust entity is not the debtor (as in a common law trust), the debtor typically is the trustee, not the trust. The trustee holds the property -- the legal title to the property -- so, the trustee is the debtor and creates the security interest in the assets. Under the 2013 amendments, however, the determination of the proper name focuses not only on the debtor -- the trust or the trustee -- but also on whether the trust is a registered organization.

These changes also relate to the location of trusts, as explained by one of the drafters of the amendments:

> To determine a debtor's *location* for purposes of filing, you need to look to trust law and the nature of the trust. [I]n common law trusts the trustee is typically the debtor. Massachusetts business trusts are common law trusts, and so the trustees are the debtors. You file against a Massachusetts business trust wherever the trustees are located under § 9-307. That is the where-to-file issue. The *name* issue is a separate issue, which is determined by the fact that, even though the trust is not the debtor, it is a registered organization. You file in the location of the trustees, but provide the trust's name as it appears in the trust's public organic record.[16]

The new location rules are explained in the comments to section 9-307 (governing the location of the debtor). First, a new paragraph has been added to comment 2 ("General Rules"):

> Questions sometimes arise about the location of the debtor with respect to collateral held in a common-law trust. A typical common-law trust is not itself a juridical entity capable of owning property and so would not be a "debtor" as defined in Section 9-102. Rather, the debtor with respect to property held in a common-law trust typically is the trustee of the trust acting in the capacity of trustee. (The beneficiary would be a "debtor" with respect to its beneficial interest in the trust, but not with respect to the property held in the trust.) If a common-law trust has multiple trustees located in different jurisdictions, a secured party who perfects by filing would be well advised to file a financing statement in each jurisdiction in which a trustee is located, as determined under Section 9-307. Filing in all relevant jurisdictions would insure perfection and minimize any priority complications that otherwise might arise.[17]

Next, comment 4 (explaining the location rules applicable to registered organizations organized under the law of a state) has been revised in an attempt to clarify the application of the statute to trusts:

> Under subsection (e), a "registered organization" *(defined in Section 9-102 so as to ordinarily include corporations, limited partnerships, limited liability companies, and statutory trusts)* organized under the law of a "State" (defined in Section 9-102) is located in its State of organization. *The term "registered organization" includes a business trust described in the second sentence of the term's definition. See Section 9-102. The trust's public organic record, typically the trust agreement, usually will indicate the jurisdiction under whose law the trust is organized.*[18]

Whether the separate legal status of a business trust can be established by the definition of a "registered organization" in the UCC remains to be seen.

In sum, the perfection rules for trusts seem to work as described in Exhibit 1 (see p. 13). The choice of words, that the rules "seem to" work as described in Exhibit 1, is intentional. These rules for trusts have been very problematic since 2001, and the 2013 amendments may resolve those problems but the result is sometimes complex, counter-intuitive and perhaps even contrary to other law regarding the status of business trusts. The idea of having a naming convention for the debtor that requires a name of an entity or individual whose location is not the place of filing seems to run counter to the most fundamental changes in the 2001 revision, which put the place of filing where the debtor is.

---

12 UCC § 9-307(b)(3).

13 UCC § 9-307(b)(1).

14 UCC § 9-102(a)~~(70)~~*(71)*. This is an extension of the new terminology, discussed in Part I, that clarifies the means of determining the name of a registered organization generally.

15 Compare Lafayette Bank & Trust Co. v. Branchini & Sons Const. Co., Inc., 32 Conn. Supp. 124, 126 342 A.2d 916, 917 (Conn. Super. Ct. 1975) (holding Maryland business trust is separate entity from its individual trustees and therefore not subject to service under Connecticut "long-arm" statute applicable to individuals and partnerships), and Swartz v. Sher, 344 Mass. 636, 639, 184 N.E.2d 51, 53 (1962) ("To be sure such trusts are not corporations, nor are they entities apart from the trustees.").

16 Harris, Kilborn & Livingston, *Perfecting and Maintaining Perfection in Article 9 Security Interests Under the 2010 Amendments: New Sections 9-503 and 9-316*, 10 DePaul Bus. & Com. L.J. 461, 479 (2012) (emphasis added) (quoting Steven Harris).

17 UCC § 9-307 Cmt. 2.

18 UCC § 9-307 Cmt. 4.

PRACTICE TIP:

When the Debtor is a Trust—These rules are probably difficult to remember, if not incomprehensible, for an insolvency advisor, especially because most are not experienced in dealing with non-bankruptcy trustees as debtors in bankruptcy. Suffice it to say that, in the situation in which a trust or trustee is the debtor in a bankruptcy, the insolvency advisor should remember that these rules are here and study them carefully. It is possible that the lender to the trust did not understand the rules, either. Determine what the debtor's or debtors' names should be for purposes of the UCC-1 and what additional information should be included and, separately, consider where the filing should be. Search in those names and states. If a search does not produce a report of the lender's filing, the insolvency advisor may have an argument that lender is not perfected.

MISCELLANEOUS INFORMATION NO LONGER REQUIRED

There are other filing rules affected by the 2013 amendments. For one, there was miscellaneous information required in the UCC-1 (the jurisdiction of the debtor, form of its organization and its ID number). This information has now been deleted from the requirements in section 9-516(b)(5).

These deleted requirements, as well as the remaining rules in section 9-516(b)(5), produced very few adverse consequences for perfection or priority under prior law,[19] but they were technical requirements that created some difficulty for those preparing the financing statement. They are no longer required.

PRACTICE TIP:

Miscellaneous Information—Studying the debtor's identification number and other minor information required by the 2001 forms was almost always a waste of time for trustees, debtors and their advisors.[20] Some of that required information has now been eliminated.

INFORMATION (FORMERLY CORRECTION) STATEMENTS

Another change that practitioners are likely to find helpful involves the fact that preparers may make mistakes when they are filing amendments or termination statements. For example, a filer may transpose digits in a filing number and refer to a third party's financing statement. If the filing is a termination statement, the resulting record suggests that the third party's filing has been terminated. Because that filing is not technically authorized, it is not effective, but it is still part of the record and cannot be wished away.

To address a part of this problem, the drafters broadened section 9-518, in 2013, so that there now is an opportunity for the secured party to do something, whereas previously only a debtor could make such a change. Also, the statute now uses the phrase "information statement" instead of "correction."

Allowing the secured party to file an information statement allows information to be provided that is similar to that previously allowed for the debtor. If the secured party is a party of record, concludes that one who has filed a record was not entitled to do so (under the general authority rules of section 9-509(d)) and believes that corrective information is required, then an information statement may be filed to provide the reasons for that conclusion. Additional information is required in the case of real estate. This helps keep a prior filing from being effective to alter another filing in an inappropriate manner. Nothing in this causes incorrect information to disappear, but it provides additional information for clarification.

PRACTICE TIP:

Information Statements—Treat information statements as clues. They may lead to a problem in a creditor's perfection.

PRE-CLOSING FILINGS

Another filing issue addressed in the 2013 amendments arises from the fact that many practitioners make filings prior to closing an Article 9 transaction. The goal in this practice is to do a filing before taking any of the other steps for perfection, so that any eventual perfection will date back to the date of filing. Before 2001, the financing statement could be filed in this way with little concern, because the debtor had to sign it. Since 2001, however, the financing statement is not signed by the debtor; the secured party can file it, but it must be "authorized" to do so by the debtor and that authorization must appear in an "authenticated record."[21] The authorization is automatic as to collateral in which the security agreement grants a security interest, but by definition, there is no security agreement at the time of a pre-filing.

Filing a financing statement prior to closing, without any written authorization, creates an issue: Does a subsequent writing (if and when the loan eventually closes) ratify the prior filing? Or, was the unauthorized filing ineffective and does it remain so? If the debtor obtains credit from a different secured party (SP2), who takes all of the steps to perfect including filing, then SP2, as intervening filer, may contend that the prior filing was not properly "authorized," and therefore not effective. No security agreement had been signed at the time it was filed. What if the subsequent signed agreement does not expressly refer to the prior filing? Common law ratification might have been sufficient and was loosely referred to in the drafters' 2001 commentary. The new commentary reinforces an argument that the authorization relates back:

[19] To reach that conclusion required a tedious analysis of several perfection and priority rules in pre-2013 Article 9. See UCC §§ 9-502(a), 9-516(b)(5), 9-520(c) & 9-338.

[20] Among the sections cited in the preceding footnote, section 9-338 requires that the party challenging the filing with incorrect information must have given value in reliance on the incorrect information. That excludes the trustee, whose status as to personal property is only that of a judgment lien creditor. 11 U.S.C. § 544(a).

[21] UCC § 9-509.

<table>
<tr><td colspan="5">EXHIBIT 1
Secured Transactions Involving Trusts: Rules for Filing after July 1, 2013</td></tr>
<tr><td>Registered Organization?</td><td>YES
9-102(a)(68)
Public Organic Record
9-102(a)(71)</td><td colspan="3">NO
Organic Record Only
(Not Public)</td></tr>
<tr><td>Name of Debtor</td><td colspan="3">Organic Record Names Trust
(9-503(a)(1)):
Trust
9-503(a)(3)(A)(i)</td><td>Organic Record Does Not Name Trust:
Settlor or Testator
9-503(a)(3)(A)(ii)</td></tr>
<tr><td rowspan="4">Place of Filing</td><td rowspan="4">State of Organization
9-307(e)</td><td colspan="2">See 9-503 Cmt 2.b. & 9-506 Cmt. 2.:</td><td rowspan="3">Where Trustee(s) Located?</td></tr>
<tr><td>Separate Legal Entity</td><td>Not Separate Legal Entity</td></tr>
<tr><td rowspan="2">Where Non-Registered Entity Located?
9-307(b)(2) & (3)</td><td>Where Trustee(s) Located?</td></tr>
<tr><td colspan="2">Trustee(s) Location:
Individual: 9-307(b)(1)
Non-Individual: 9-307(b) (2)&(3) or (e)</td></tr>
<tr><td>Additional Information Required?</td><td>NO</td><td colspan="2">Information Required
9-503(a)(3)(B)(i)</td><td>Information Required
9-503(a)(3)(B)(ii)</td></tr>
</table>

Amendments *continues on p. 23*

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Ralph Tuliano
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William L. Wallander
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Bankruptcy Taxes

Forrest Lewis, CPA
Section Editor

BANKRUPTCY TAX LEGISLATION CHANGES NEEDED

Based on reported cases and anecdotal sources, these are some areas in which Congress needs to make changes to existing bankruptcy tax provisions, be it in the Internal Revenue Code or the Bankruptcy Code:

1. Substitute for Return as a Dischargeable Tax Return

When the Internal Revenue Service detects an individual taxpayer who has not filed an individual tax return for a year, it sends the individual a series of letters and finally IRS prepares a "substitute for return" (SFR) if the individual does not file. In some cases the individual is cooperating with the IRS and signs the substitute as described in IRC Section 6020(a). But in some cases the individual has moved and does not receive the notices or refuses to cooperate; so the substitute is not signed by the taxpayer, as described in Section 6020(b). In order to be dischargeable, Bankruptcy Code Section 523 has always required that the taxpayer sign the return; in addition, the taxes have to meet the "old and cold" tests—generally three years. However, a 2006 BAPCPA change made it more difficult for an individual to obtain a discharge by adding the following sentence to the law: "For purposes of this subsection, the term 'return' means a return that satisfies the requirements of applicable nonbankruptcy law (including applicable filing requirements)." This has been interpreted by the courts to mean that the substitute return had to be timely filed (9½ months or less after year end), which rarely happens.

The IRS has somewhat improved the situation by publishing an internal policy providing that a taxpayer can file an amendment after the SFR which will be respected as a return and any additional tax shown on the amendment can qualify for discharge (SBSE-05-0911-078).

Returning to the primary issue, the effect of the 2006 change can be illustrated as follows:

> *Example 1*—Individual A fails to file a 2009 Form 1040. Because IRS has received several 1099 forms for A, it is aware he has failed to file. The Collections Division contacts A in 2011 and he is cooperative but slow to act. IRS prepares a substitute return showing A owes $5,000 and A signs it but currently does not have the money to pay. Because the substitute return was not filed within the normal return time limits in 2010, the $5,000 can never be discharged, no matter how much later A may file a petition in bankruptcy.

Commentary

Certainly, there need to be incentives for individuals to file in our voluntary tax system. It is probably also true that by inducing individuals to file complete returns, more tax liability is identified than would be shown on substitute returns prepared by the IRS. However, I question how much of tax levied by this very punitive rule is ever collected, especially when weighed against the amount litigation it is creating. Even if nondischargeable in bankruptcy, if still unpaid after 10 years the tax will ultimately be abated. There are already severe financial penalties and interest for failing to file, but these do not result in 100% compliance either. It appears the BAPCPA change only removes the incentive for the individual to cooperate. Under prior law, if the taxpayer cooperated and signed the substitute return, there was a chance the taxes would ultimately be dischargeable. Now, in most cases the taxes as shown on the substitute return cannot be discharged whether the taxpayer cooperates or not, thus forcing litigation as the only possible out. It would be better to go back to the pre-BAPCPA rule that substitute returns signed by the taxpayer can be discharged.

2. Deadline for Individual Filing Chapter 7 or 11 Petition to Elect Split Year

When an individual files a petition in Chapter 7 or 11, under IRC Section 1398 he has an option to elect to cut off his tax year on the day before the petition and split the tax year into two periods. The election is made by filing a tax return (or extension) within 3½ months after the petition date. Though the election is usually beneficial, it is often missed because it falls within the taxpayer's calendar year. If the election is not made, all of the individual's favorable tax attributes pass to the taxable estate for the year including net operating losses, capital losses, etc.

> *Example 2*—Tom has been incurring losses for several years in his construction business operated as a sole proprietorship. On June 1, 2013 when he has an accumulated net operating loss of $100,000, he files a petition in Chapter 7. His wife earned $60,000 for 2013. Because no split year election was filed, his net operating loss passed to the taxable bankruptcy estate on June 1 and is not available to offset her taxable wages for 2013.

Usually this type of situation is discovered after year end in the process of preparing the tax returns; but then it is too late to make the election.

Commentary

The election should be permitted to be made until the due date of the calendar year individual tax return; i.e., April 15 or October 15 with extension. As it stands, it is just a trap for the unwary.

3. Extension of 505(b) to Pass-Through Entities

Bankruptcy Code Section 505(b) brings a great deal of closure to bankruptcy estate tax controversies by allowing a trustee to request a prompt determination of most types of taxes from the relevant governmental unit. Generally, a taxing unit receiving such a request has 60 days to notify the trustee of any audit or adjustment and 180 days to complete any audit initiated in the 60 day period—otherwise, assessment is barred. Currently, the IRS takes the position this privilege is only available to "tax paying" entities such as a C (regular) corporation or a complex trust; it does not extend to pass-through entities such as grantor trusts, partnerships and S corps.

Commentary

Because of the good policy reasons behind the prompt closure to tax matters which this provision allows, it should be extended to all types of entities which affect determination of tax.

4. Characterization of Estate Expense as Business Expense

This is a subtle point and I have not seen the IRS raise this specific issue but it may be just a matter of time. Former Bankruptcy Code Section 346(e) provided that when an estate paid a business or administrative expense, it was deductible as a business expense. Generally business deductions are the highest level of deductible expenses and subject to the fewest limitations. But that section was so completely overhauled in BAPCPA, the subsection referred to was completely deleted. Now, it is no longer clear that former business expenses retain their character as business deductions. Further, the basis for deduction of administrative expenses is no longer clear. While it makes common sense that estate administrative expenses are deductible, what is the authority for that and what is their treatment for alternative minimum tax purposes?

Commentary

The essence of the former 346(e) should be added back to the Bankruptcy Code.

5. No Limitation for Interest on State and Local Tax Claims

AIRA Executive Director, Grant Newton first brought my attention to this change made by BAPCPA. Under new Bankruptcy Code Section 511, for tax claims, applicable nonbankruptcy law controls. Though the IRS has a market-based interest rate on tax liabilities, state and local rates are all over the board. Some have been used as a surrogate penalty, amounting to as much as 12%.

Commentary

All creditors, especially all tax creditors, should be treated equally. The IRS interest rate should be implemented as a ceiling on all types of tax claims.

6. Create Bankruptcy Estate Tax Return

AIRA's Executive Director, Grant Newton, CIRA, notes that it would be much more convenient if IRS would create a bankruptcy estate tax return for the estate of an individual in Chapter 7 or 11. Currently, the IRS instructions say to basically use Form 1040, make appropriate adjustments and attach the first page of Form 1041, the trust return to it. However, there are several concepts to individual bankruptcy estates such as the administrative expense carryforward and "gross up" of tax rates in the year of commencement which are foreign to the 1040. Experience shows that the IRS computers have difficulty processing individual bankruptcy estate returns.

Commentary

IRS should create an individual bankruptcy estate tax form and appropriately program its computers to process it.

IRS AUTHORIZES REJECTION OF OFFER IN COMPROMISE BECAUSE OF ADVERSE PUBLIC REACTION

Internal Revenue Service Collections Division employees may reject a taxpayer's settlement offer on the basis of possible negative public reaction, even if the offer is more than what could be collected by other means, the Internal Revenue Service said. (SBSE-05-1013-0076). The Small Business/Self-Employed Division outlined multiple bases for rejecting an offer in compromise as either not in the best interest of the government or for public policy reasons.

The guidance under Internal Revenue Manual Section 5.8.7, dated Oct. 23, 2013 requires that IRS take into account a taxpayer's prior history of noncompliance; ability to fund an offer, remain current with future tax obligations and maintain normal business operations; and whether public reaction to an acceptance would "be so negative as to diminish future voluntary compliance." "Rejections under this provision should not be routine and should be fully supported by the facts outlined in the rejection narrative," the IRS said. Taxpayers must be fully informed of the reason for rejection and provided the opportunity to withdraw the offer prior to submission of the offer rejection recommendation, the memorandum said.

Commentary

The IRS memorandum notes that offer acceptances are open to public inspection, though it would seem that there would only be public interest in cases involving well known persons or taxpayers whose cases are being followed closely by the press.

IRS ISSUES FURTHER INTERNAL GUIDANCE ON PONZI SCHEME PHANTOM INCOME

The Internal Revenue Service recently released some very helpful internal guidance on how to treat several situations involving "phantom income" in Ponzi schemes that investors reported as taxable income in years before the fraud was discovered. Technically, it says that the new ruling cannot be used or cited as precedent, but the IRS knows that these are made public and it comes from the Office of the Chief Counsel which is the group that will be the ultimate arbiter of these issues in the future within the IRS. The ruling essentially deals with taxpayers who amend their tax returns to eliminate "phantom income" on Ponzi scheme investments which was reported to the investor and included on the investor's tax return. Phantom income is basically investment income which was not received in cash. The new ruling is aimed at those who do not elect the safe harbor under Revenue Procedure 2009-20 which essentially says a victimized investor can take a 95% theft loss deduction for the basis in their investment in the year of discovery. The new ruling allows eligible taxpayers to amend open tax years and claim refunds for tax paid on "phantom income". However, phantom income reported by the taxpayer in closed years must be added to tax basis and deducted as part of the overall theft loss in year of discovery. Closed year tax returns cannot be amended. Various scenarios are illustrated (PMTA 2013-03).

CONSOLIDATED RETURN REGULATIONS HELP/HURT WHEN THERE ARE NET OPERATING LOSSES

The pertinent federal consolidated income tax return regulations contain some provisions which are favorable to troubled companies which have net operating losses and some which are unfavorable:

Net Operating Loss Carryovers Computed on Consolidated Basis

This is a very favorable attribute since losses incurred by some group members can be applied against current year income of profitable subs or carried back or forward to income of profitable subs (Regulation 1.1502-21).

Limitations on Consolidated Net Operating Losses

There are several limitations on the use of net operating losses:

- Separate return limitation years (SRLY)—when a corporation having a net operating loss carryforward joins the group, it can be subject to this rule which essentially puts the use of the loss on a separate return basis (1.1502-21(c)(1)).
- Loss disallowance rules—apply when there is a loss deduction taken in the following situations:
    - Resulting from differences in the tax basis in the shares of the shareholder (1.1502-36(b)).
    - When there is a non-economic duplication of a loss which usually results from acquisitions of existing corporations with "inside and outside" basis differences (1.1502-36(d)).

Section 382 Limitation Where Change of Ownership Is Computed on Consolidated Basis

When there is a change of ownership of the group, Internal Revenue Code Section 382 requires that net operating loss carryforwards only be used on an "amortization" method based on the selling price times the IRS rate of interest. Fortunately for the group, the Section 382 limit is computed on a consolidated basis meaning the selling price of the entire group is used, most likely resulting in a higher annual limit for the "amortization" use of the loss. (There are some special provisions under Section 382 for corporations in bankruptcy which can ameliorate the limitations of Section 382; see D. Joshua Elliott's article in this column in Volume 27 Number 1, April-June 2013, p. 17-18.)

Continuity of Business Enterprise Treated on Consolidated Basis

One of the requirements under Section 382 to preserve net operating losses after a change of ownership is the "continuity of business enterprise" test. Fortunately, the consolidated return regulations contain an example in which a loss group which had three historic lines of business but drops two of them. As long as one of the historic lines of business is maintained, they successfully meet the requirement (1.1502-93(d)).

Fan-Out of Attribute Reduction When There Is Cancellation of Debt Income

When there is cancellation of debt (COD) income in a consolidated group which is excluded from taxable income under Section 108, usually because of bankruptcy or insolvency, favorable tax attributes—primarily net operating losses, must be reduced. When the amount of COD exceeds the net operating loss carryforward of the subsidiary realizing the COD, the net operating losses of other group members are reduced, known as the "fan out." This unfavorable reduction of net operating loss carryforwards by members not in bankruptcy can be a very unwelcome surprise (1.1502-28(a)(4)).

Thanks to Grant Newton and Dennis Bean for their assistance with this article.

***Forrest Lewis, CPA** is a tax practitioner based in East Lansing, Michigan.*

Baxter Dunaway Retires as *AIRA Journal* Section Editor

At its 27th Annual Conference in San Francisco, June 2012, AIRA recognized Professor Baxter Dunaway, Professor Emeritus of Pepperdine University's School of Law, for his lifetime contribution to AIRA Journal. Baxter was instrumental in initiating Distressed Business & Real Estate Newsletter (DB & RE Newsletter), AIRA Journal's predecessor, during the real estate crisis of the 1980s. He provided direction and vision to bring about a publication that would specifically address troubled business and real estate. In April 1986 the first DB & RE Newsletter was printed by Westlake Publishing; a few years later AIRA arranged for members to receive the Newsletter as a wrap-around with AIA News (reflecting AIRA's earlier association name, Association of Insolvency Accountants); and in 2001, AIRA purchased the Newsletter from Westlake Publishing and combined the two original newsletters into a single publication, subsequently renamed AIRA Journal.

From the inception of DB & RE Newsletter to the present, Baxter has written articles for every issue of the Journal and its predecessors—spanning a period of almost 28 years. His columns and articles have provided readers with summaries and analyses of many hundreds of decisions by bankruptcy courts and courts of appeal on bankruptcy, restructuring and related issues. AIRA Executive Director, Grant Newton, said Baxter Dunaway's contribution has been invaluable and deeply appreciated and expressed best wishes on behalf of the Association to Baxter and his wife, Deon, in their retirement in San Luis Obispo.

BANKRUPTCY CASES

Professor Baxter Dunaway

SEVENTH CIRCUIT

"Strip Off" of Bank's Second-Priority Mortgage

Alejandro PALOMAR, Sr., and Rafaela Palomar, Plaintiffs–Appellants, v.FIRST AMERICAN BANK, Defendant–Appellee. No. 12–3492. Palomar v. First American Bank--- F.3d ----, 2013 WL 3466884 (C.A.7 (Ill.)) Decided July 11, 2013.

Chapter 7 debtors in no-asset case brought adversary proceeding against bank, seeking to "strip off" bank's allegedly worthless second-priority mortgage on their residence. Concluding that the action was meritless, the United States Bankruptcy Court dismissed the proceeding. Debtors appealed. The District Court (2012 WL 4739407) affirmed, and debtors appealed.

Holding: The Court of Appeals held that debtors could not "strip off" bank's second-priority mortgage. Affirmed.

Mr. and Mrs. Palomar filed for bankruptcy under Chapter 7 of the Bankruptcy Code in July 2011, and a trustee was appointed. A month after the filing the trustee reported that the estate in bankruptcy contained nothing that could be sold and yield money for the Palomars' unsecured creditors. So a discharge of their dischargeable debts was entered and in December the bankruptcy case was closed.

The day before the trustee issued his no-asset report, the Palomars had filed in the bankruptcy court an adversary action against First American Bank, which held (and holds) a second mortgage on their home. The original amount of the loan secured by the mortgage was $50,000, but the current balance is unknown and the bank has not bothered to file an appearance in the adversary action. Another lender, LBPS (IBM Lender Business Process Services, Inc., recently renamed Seterus), had and has a first mortgage on the Palomars' home on which the unpaid balance when the Palomars filed for bankruptcy was $243,000—yet the home was valued then, according to an appraisal attached to the debtors' complaint, at only $165,000. The Palomars argue that the second mortgage was worthless and should therefore be "stripped off"—that is, dissolved by order of the bankruptcy court. As authority they cite 11 U.S.C. § 506(a). The accuracy of the appraisal has not been questioned, though the Palomars had an incentive to obtain a low appraisal in order to bolster their argument for the stripping off of the second mortgage.

By the time the adversary action was ready to be decided by the bankruptcy judge, the bankruptcy had been closed. The judge could have reopened it "to accord relief to the debtor," 11 U.S.C. § 350(b), as by stripping off a lien (if that would be proper relief), provided that the Palomars had not been responsible for a delay in pressing their suit that would have harmed the creditors (that is, provided that the Palomars had not been guilty of laches). *In re Bianucci,* 4 F.3d 526, 528 (7th Cir.1993); *In re Beaty,* 306 F.3d 914, 923 (9th Cir.2002). But deciding that the adversary action was meritless, the judge refused to reopen the bankruptcy proceeding and instead dismissed the adversary action. The district court affirmed and the Palomars appealed to the 7th Cir. First American Bank has not appealed.

So far as relates to the appeal, section 506(a) of the Bankruptcy Code states that "an allowed claim of a creditor secured by a lien on property ... is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property ... and is an unsecured claim to the extent that the value of such creditor's interest ... is less than the amount of such allowed claim." Section 506(d) states that "to the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such lien is void." *In re Tarnow,* 749 F.2d 464, 465–66 (7th Cir.1984), explains that these provisions are best interpreted as confirming the venerable principle of *Long v. Bullard,* 117 U.S. 617, 620–21, 6 S.Ct. 917, 29 L.Ed. 1004 (1886), that bankruptcy law permits a lien to pass through bankruptcy unaffected, provided that it is a valid lien and secures a valid claim ("an allowed secured claim"). The holder of such a claim can if he wants ignore the bankruptcy proceeding and enforce his claim by foreclosing the lien. But alternatively he can file the claim in the bankruptcy proceeding, which will be an unsecured claim to the extent that it exceeds the value of the collateral. The upside of this way of proceeding is that if the claim exceeds that value, yet the debtor has assets sufficient to enable the excess at least or a portion of it to be paid in satisfaction of an unsecured claim, the creditor will be better off than by foreclosing his lien. The downside is that the claim may be disallowed, in which event the lien will be avoided; for all a lien is security, so if there is nothing to secure, the lien is down the drain. The bankruptcy court's invalidation of a lien, if not reversed, will operate as collateral estoppel should the creditor later try to foreclose, that is, try to enforce the lien.

Note, however, that *partial* disallowance of a lien creditor's secured claim does not invalidate the lien, but merely shrinks it. "If a party in interest requests the [bankruptcy] court to determine and allow or disallow the claim secured by the lien under section 502 and the claim is not allowed, then the lien is void"—but only "to the extent that the claim is not allowed." H.R. Rep. No. 95–595, 95th Cong., 1st Sess. 357 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6313.

If, however, as *Tarnow* teaches when read alongside such later decisions as *In re Talbert,* 344 F.3d 555, 560–61 (6th Cir.2003), and *Ryan v. Homecomings Financial Network,* 253 F.3d 778, 781–82 (4th Cir.2001), the only lien voided by section 506(d) in whole or part is one securing a claim rejected in whole or part by the bankruptcy court, the statute has no application to this case. First American's claim was not rejected by the bankruptcy court—it filed no claim. No one did; this was a no-asset bankruptcy. And so the bank was free to foreclose its lien outside of bankruptcy. Nor is there any suggestion that had the bank filed a claim it would have been rejected. It has not foreclosed, yet only (we suppose) because at present the Palomars' home is worth less (unless the appraisal is grossly inaccurate) than the sum of the first and second liens on it, the bank's lien being the second. In fact it is worth less than the first lien, that of LBPS alone; but someday the house may be "above water," at which point First American may decide to foreclose.

The holdings in *Tarnow, Talbert*, and *Ryan* are supported (as noted in *Talbert*, 344 F.3d at 560, and *Ryan*, 253 F.3d at 781–82) by the Supreme Court's post-*Tarnow* decision in *Dewsnup v. Timm*, 502 U.S. 410, 112 S.Ct. 773, 116 L.Ed.2d 903 (1992), which holds that section 506(d) does not allow the bankruptcy court to squeeze down a fully valid lien to the current value of the property to which it is attached. See *id.* at 417–18, 112 S.Ct. 773. That is the relief the debtor in this case is seeking. The only difference between this case and *Dewsnup* is that our debtors want to reduce the value of the lien to zero. They point to section 506(a), which makes a "claim of a creditor secured by a lien on property" a "secured claim" only "to the extent of the value of such creditor's interest in [the] property." That value, the Palomars note, currently is zero. But *Dewsnup* treated the undersecured loan in that case as a "secured claim" within the meaning of section 506(d), and in so doing denied that "the words 'allowed secured claim' must take the same meaning in § 506(d) as in § 506(a)." *Id.* at 417, 112 S.Ct. 773. The point of section 506(a) is not to wipe out liens but to recognize that if a creditor is owed more than the current value of his lien, he can by filing a claim in bankruptcy (rather than bypassing bankruptcy and foreclosing his lien) obtain, if he is lucky, some of the debt owed him that he could not obtain by foreclosure because his lien is worth less than the debt.

The Palomars point out that liens on residential property can be stripped off in bankruptcies under Chapter 13 of the Bankruptcy Code, the counterpart for individual debtors of Chapter 11, which governs corporate reorganizations. A Chapter 13 plan can "modify the rights of holders of secured claims, other than a claim secured only by security interest in real property that is the debtor's principal residence, or of holders of unsecured claims." 11 U.S.C. § 1322(b)(2). And despite the exception, courts allow a Chapter 13 plan to eliminate a secured junior claim (such as a claim secured by a second mortgage) against residential property if the security interest no longer has value because what the debtors owe holders of liens senior to this creditor's lien (the holder of a first mortgage for example) exceeds the value of the property. See *In re Bartee*, 212 F.3d 277, 292–95 (5th Cir.2000); *In re McDonald*, 205 F.3d 606, 615 (3d Cir.2000). That is what the Palomars want now, but to get it they would have had to file for bankruptcy under Chapter 13 rather than Chapter 7. The strip-off right in Chapter 13 is a partial offset to the advantages that Chapter 13, relative to Chapter 7, grants creditors, such as access to a larger pool of assets because the debtor must commit all disposable income for three to five years to repaying his unsecured debts. 11 U.S.C. § 1325(b)(1)(B).

The difference between Chapter 13 (also Chapter 11) and Chapter 7 is the difference between reorganization and liquidation. In the latter type of bankruptcy the debtor surrenders his assets (subject to certain exemptions) and in exchange is relieved of his debts (with certain exceptions), thus giving him a "fresh start." But in a reorganization the assets are not sold—the enterprise continues—though ownership is transferred from the debtor to his creditors. Chapter 13 is only analogous to a reorganization; the debtor does not become a slave. But unlike what happens in a Chapter 7 bankruptcy, his assets are not sold; instead he pays his creditors, over a three- or five-year period, as much as he can afford. 11 U.S.C. § 1325(b). Often this makes the creditors better off than they would be in a liquidation; for the assets, though important to the debtor, may have little market value.

The Palomars point out that liens can sometimes be stripped off even in Chapter 7 bankruptcies. See 11 U.S.C. §§ 522(f), 722. The cited provisions relate, however, to liens on property that is exempt from creditors' claims. Section 522(f) allows the debtor to reduce a lien on exempt property so far as is necessary to preserve the exemption, while section 722 allows a debtor to redeem "tangible personal property intended primarily for personal, family, or household use, from a lien securing a dischargeable consumer debt" by paying the current value of the lien. Both provisions support the "fresh start" policy of Chapter 7, consistent with the aim of bankruptcy law of balancing the bankrupt's interests against his creditors' interests. In any event, sections 522(f) and 722 are not available to the Palomars—and "fresh start" is not an ambulatory policy invocable whenever a debtor makes an appeal to judicial sympathy.

And if there were such a principle it would not be applicable to this case. Given the gross disparity between the current market value of the Palomars' home and the claims secured by it, First American Bank is unlikely, to say the least, to foreclose in the immediate or near future. For that would entail the bank's incurring legal expenses to obtain the ownership of property worth less than the first mortgage on the property; the bank would be compounding its loss. So all that failing to extinguish First American's lien does from a practical standpoint is deprive the debtors of the chance to make some money should the value of their home ever exceed the balance on LBPS's first mortgage. It is hard to see how the deprivation of so speculative a future opportunity could be thought to impair the debtors' ability to make a fresh *start.* The extinction of the lien would not enable them to obtain a new second mortgage (unless from a predatory lender) or otherwise improve their financial situation.

AFFIRMED.
C.A.7 (Ill.),2013.
Palomar v. First American Bank--- F.3d ----, 2013 WL 3466884 (C.A.7 (Ill.))

Baxter Dunaway *is Professor Emeritus at Pepperdine University School of Law.*

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CIRA candidates appear with the President of the Puerto Rico Society of CPAs, Aníbal Jover Pagés, CPA (eighth from left). On either side of the president are Jose Monge Robertin, CPA, CIRA (at right), and AIRA's Executive Director, Grant Newton (at left).

***Amendments** continued from pg. 13*

> Under a notice-filing system, a filed financing statement indicates to third parties that a person may have a security interest in the collateral indicated. With further inquiry, they may discover the complete state of affairs. When a financing statement that is ineffective when filed becomes effective thereafter, the policy underlying the notice-filing system determines the "time of filing" for purposes of subsection (a)(1). For example, the unauthorized filing of an otherwise sufficient initial financing statement becomes authorized, and the financing statement becomes effective, upon the debtor's post-filing authorization or ratification of the filing. See Section 9-509, Comment 3. Because the notice value of the financing statement is independent of the timing of authorization or ratification, the time of the unauthorized filing is the "time of filing" for purposes of subsection (a)(1).[22]

Thus, the drafters would say that those who check the records will not be hurt by the result suggested by the new comment and that, in fact, this is what they should expect. The issue of authorization or ratification does not change the notice value of the prior filing. After all, if the later-filed secured party cared about priority, it could have checked the records for the prior filing and been put on inquiry notice.

It is a better practice to file with written authorization. If the creditor fails to do so, the trustee, as a hypothetical judgment lien creditor, may argue that many judgment liens are obtained by involuntary creditors, like tort plaintiffs, who had no opportunity to check the records.

PRACTICE TIP:

Pre-Filed UCC-1—The insolvency advisor should inquire about the creditor's authorization, if a filing appears on the record before the security agreement is signed.

TRANSMITTING UTILITIES

Under the 2001 revision, a filing in which the debtor is a transmitting utility may be designated as a transmitting utility filing and will not lapse, but will continue to be effective until terminated. However, some filers were apparently unaware that they had this option and failed to make the designation. The question that arose was whether someone could then amend a filing, which had originally been done in such a form as to expire in five years. Filing systems may not have been capable of tracking such a modification and effectively extending the life of the five-year filing. A statutory change in the 2013 amendments provides that if one wishes to make a transmitting utility filing, this must be indicated in the initial financing statement, if at all. So, the rule has been clarified, simply by adding the word "initial" to the provision that a transmitting utility financing statement would last forever.

22 UCC § 9-322 Cmt. 4.

PRACTICE TIP:

Transmitting Utility—Watch for a UCC-1 that may have inadvertently been filed without opting into the delayed-lapse rule available for transmitting utility filing. If it has been on record more than five years and the five years expired before the bankruptcy was commenced, the insolvency advisor may argue that the security interest is no longer perfected.

CORPORATE CHANGES

The 2013 amendments also contain new rules related to changes in corporate form. For example, an entity, perhaps a limited partnership, might merge into an LLC. Some but not all corporate statutes say that upon the conversion, the resulting entity is the "same" entity. In that case, if it is the same entity, the secured creditor of that debtor will only need to change the name of the debtor on the financing statement, according to a new Comment 5 to section 9-512. If that is not the wording of the corporate statute, however, it may be necessary to do a new filing against a new entity. There was some concern, based on the wording of the instructions to the forms, that it was not possible to do both. The new Comment reviews these circumstances and explains that it is acceptable to do both,[23] given the possibility of uncertainty in determining the effect of the underlying corporate law.

The same question arises if there is a merger with a "new debtor" and no filing beforehand. What the 2013 amendments do is to provide a more forgiving four-month grace period within which to make the filing against the new debtor.[24] If the secured party files within the four months, then it will be effective for property acquired in the meantime. The priority rules, however, give priority to a new secured party who does a filing in the meantime. If the old secured party files in the new jurisdiction and there was a secured party previously filed in the new jurisdiction, then that secured creditor with the prior filing in the new jurisdiction also maintains priority.

23 "When the governing statute does not clearly resolve the question, a secured party whose debtor is the converting organization may wish to proceed as if the statute provides for both results. ... The secured party also may wish to file another financing statement naming the resulting organization as debtor." UCC § 9-512 Cmt. 5 (new).

24 UCC § 9-316(h)&(i). A new comment 7 to section 9-316 explains with an example: "Example 9: Debtor, an individual whose principal residence is in Pennsylvania, grants to Lender a security interest in Debtor's existing and after-acquired inventory. Lender perfects the security interest by filing a proper financing statement in Pennsylvania on January 2, 2014. On March 31, 2014, Debtor's principal residence is relocated to New Jersey. Upon the relocation, New Jersey law governs perfection of a security interest in Debtor's inventory. See Sections 9-301, 9-307. Under New Jersey's Section 9-316(a), Lender's security interest in Debtor's inventory on hand at the time of the relocation remains perfected for four months thereafter. Had Debtor not relocated, the financing statement filed in Pennsylvania would have been effective to perfect Lender's security interest in inventory acquired by Debtor after March 31, 2014. Accordingly, under subsection (h), the financing statement is effective to perfect Lender's security interest in inventory that Debtor acquires within the four months after Debtor's location changed."

In Example 9, Lender's security interest in the inventory acquired within the four months after Debtor's relocation will be perfected when it attaches. It will remain perfected if, before the expiration of the four-month period, the security interest is perfected under the law of New Jersey. Otherwise, the security interest will become unperfected at the end of the four-month period and will be deemed never to have been perfected as against a purchaser for value. See subsection (h)(2).

For other kinds of changes, such as a change in location, there are more statutory amendments in sections 9-314(h) and (i) and 9-326. The security interest is not perfected in any collateral acquired after the change, unless a financing statement is filed in the new state, but the security interest will remain perfected in post-change collateral for four months after the change and will continue to be perfected if a financing statement is filed in the new state during the four-month period.

Due diligence is of course important in a new transaction and continued diligence is also necessary going forward. In making any loan, it is important to investigate whether the debtor has recently been through a reorganization, merger or consolidation, because another secured party might have priority, resulting from its earlier filing against the new debtor or in the new location. Similarly, if a secured party becomes aware that its borrower is engaging in some transformative activity, such as selling its assets, merging, reincorporating or converting into a different entity, then it is very important to be aware of the amended rules, including the comments, which can be particularly helpful.

PRACTICE TIP:

Changes in the Debtor—Inquire carefully about the history of a debtor, either corporate or individual. Be alert for moves, name changes, corporate acquisitions, mergers, etc., which may change the debtor's location or affect a creditor's filing in another way.

Location Changes Generally—Remember that if the state in which a debtor is located changes, the security interest generally continues perfected, based on the filing in the former state, *only* as to collateral that existed at time of the change, *only* for four months afterward and *only* if there is a filing in the new location during the four months, without which it becomes unperfected.

CHATTEL PAPER — ELECTRONIC AND OTHERWISE

Other new rules address methods of perfection involving chattel paper that is partially paper and partially electronic. Before 2001, we had chattel paper; then we had electronic chattel paper. The perfection rules related to chattel paper require possession or marking the collateral for complete perfection. Electronic chattel paper, however, by its nature, cannot be possessed or marked, so it must be perfected by "control," which is a complex technological task, made slightly easier by the 2013 amendments.

The 2013 amendments attempt to anticipate further changes in the process. However, it is conceivable that one could have chattel paper that starts out as paper but is amended electronically. What does a secured party need to do to ensure that it is perfected by possession and/or control? It cannot "control" everything because some of the collateral is paper and it cannot possess everything because some is electronic. The amended commentary explains at length that the secured party must take possession of the paper and must still maintain control of the electronic components of the collateral.[25] Like the Enjoli woman,[26] the secured party must do it all.

[25] UCC § 9-330 Cmt. 4.

[26] Google it.

The first example dealt with in the 2013 amendments is a certificate of title, which is increasingly likely to be electronic. The changes attempt to make it clear that a certificate of title need not be on paper.[27] Again, it could even be both, if a jurisdiction issues a piece of paper accompanied by an electronic record of security interest.[28] If the title statute (which is not part of the UCC) speaks of perfection by notation on the certificate, how is that done? The amendments attempt to make it clear that the paper and the electronic record are together treated as the certificate of title, reflecting the need to make these concepts medium-neutral.

PRACTICE TIP:

Chattel "Paper"—Insolvency advisors should be alert to this evolving area, which contains traps for unwary creditors. Absent a UCC-1 filing (which will still trump the bankruptcy trustee), the conversion of chattel paper, in whole or in part, into an electronic form may require the creditor to perfect its interest in that collateral by control, which is a term with a highly technical meaning, detailed in the statute. Insolvency advisors, like creditors, should obtain technological support as they explore this new world.

With respect to electronic chattel paper itself, the 2013 amendments reflect advances in practice and the realization that the 2001 revision's attempt to accommodate the continuing evolution of virtual transactions may have needed improvement. In 2001, the intent was to create a system that could be used to obtain something equivalent to possession ("control") in the case of electronic collateral. No one could know with certainty how these systems would develop. The definition of control[29] was very specific and was borrowed from other uniform acts. There were six requirements, such as a single identifiable record, but these concepts were somewhat static in time and difficult to apply.

The 2013 amendments borrowed from other statutes, such as the Uniform Electronic Transactions Act. Now a secured party has control of electronic chattel paper if the "system employed for evidencing the transfer of interests in the chattel paper reliably establishes the secured party as the person to which the chattel paper was assigned."[30] The six requirements established in 2001 are now a safe harbor.[31] Thus, the rule is somewhat more flexible; the original, precise, multi-step option is still a safe harbor, but there is a more conceptual approach embodied in the new provision.

CLASSIFICATION OF COLLATERAL

There are a number of changes in comments in the 2013 amendments that address the characterization of property. Some dealt with some specific problems highlighted by cases decided since 2001.

In *Highland Capital Mgmt. L.P. v. Schneider*,[32] a question was certified to the highest court in New York from the Second Circuit, to

[27] UCC § 9-102(a)(10).

[28] UCC § 9-102 Cmt. 11.

[29] UCC § 9-105.

[30] UCC § 9-105(a) (new).

[31] UCC § 9-105(b).

[32] Highland Capital Mgmt. L.P. v. Schneider, 8 N.Y.3d 406, 866 N.E.2d 1020, 834 N.Y.S.2d 692 (2007).

interpret the language in the UCC that explains what a "security" is. The fact pattern involved promissory notes and the question was whether the notes were "investment property." Section 8-102(a)(15) defines a security in part by whether it "may be registered." The *Highland* court said that anything that could conceivably be registered would be a security, so the notes fell within the definition contained in section 8-102(a)(15).[33] New commentary, published with the 2013 amendments, disagrees with that conclusion, saying that the registerability requirement is satisfied "only if books are maintained by or on behalf of the issuer." [34] It is not sufficient that the issuer simply maintains books for other purposes or that it could hypothetically maintain books for the purpose of registering a note, "for such is always the case."[35] There must be books actually maintained for the purpose of registering this particular property. Another collateral-classification issue that appeared in the Article 9 case law after 2001 is the characterization of payment rights that arise out of an equipment lease, reflected in *In re Commercial Money Center, Inc.*,[36] and related decisions. The Ninth Circuit Bankruptcy Appellate Panel held in *Commercial Money Center* that if the lessor assigns only the payment rights flowing from an equipment lease, those rights will be properly characterized as payment intangibles, instead of chattel paper. A true sale of a payment intangible is automatically perfected. However, the Court went on to hold that the transaction was not a sale. An amendment of Comment 5.d. to section 9-102 says that payment rights derived from chattel paper, even if other rights are renounced by the assignee, do not deprive the payment stream of its character as "chattel paper" instead of "payment intangibles."[37] Thus, it may be easier to have some certainty about the character of the payment rights in equipment leasing.

PRACTICE TIP:

Classification of Collateral—Insolvency advisors know, of course, that proper classification of collateral is critical to describing it on the UCC-1 and determining where to file the form. These cases and the drafters' reaction to them emphasize that importance.

ENFORCEMENT ISSUES

Payment Rights

The 2013 amendments also address some issues that have arisen in the enforcement of security interests after default. One addresses a security interest in a payment right that has some limitation on transfer. Sections 9-406 and 9-408, and their pre-2001 counterparts, have long contained a set of anti-assignment override provisions that became more complex in 2001, with section 9-406 being a broader set of override rules, in the case of a security interest in a payment right. However, if there has been a sale of that payment right, does the sale move the transaction under section 9-408, which is more restrictive and applies more clearly to sales of promissory notes? The drafters in the 2013 amendments attempted to make it clear that the foreclosure sale of the note would remain under section 9-406.[38] This may be seen as an attempt to assist third parties with the difficulties they have encountered after the financial crisis that accompanied the drafting of these changes.

Internet Sales

Another set of enforcement-related provisions in the 2013 amendments address the possibility of a sale of collateral through the Internet. The new comments attempt to clarify the rules applicable to that situation. Practitioners have wrestled with the process of giving sufficient information about the time and place of such a sale on the Internet and the courts have not been unsympathetic with their efforts.[39] The drafters' response was not a statutory change, but simply a clarification; the drafters may have thought that the evolution in this area makes it inappropriate to try to lock a set of firm rules into the statute. Sales that may be commercially reasonable include "public and private dispositions conducted over the Internet."[40] This new commentary, discussing the contents of notification, has also been amplified with a comment that says notification of the time and the "electronic location," defined as the URL (Uniform Resource Locator) or other identifier of the place on the Internet, as that concept existed in 2010, suffices as a place for the sale.[41]

Recording to Reflect New Note Order

Where the collateral is a note secured by a mortgage, sometimes the parties do not record an assignment of the mortgage. In fact, Comment 9 to section 9-203 emphasizes that "subsection (g) codifies the common-law rule that a transfer of an obligation secured by a security interest or other lien on personal or real property also transfers the security interest or lien," so such recording should not be necessary.[42] Article 9 provides that, if the secured party is the holder of the note but is not the mortgagee of record, then in the case of a non-judicial foreclosure sale, it can file a sworn statement with the local real estate office, saying that it is entitled to enforce the note and that a default has occurred.[43] The 2013 amendments clarify that the reference to a default having occurred is a reference to a default "with respect to the obligation secured by the mortgage" (i.e., a default by the mortgagor), to avoid the possible construction of the language to mean a default by the seller of the note (also referred to as a "debtor") and not by the mortgagor. This also has larger implications in the context of the economic crisis that began before the 2010 promulgation of the amendments. Article 9 attempts to permit the secured party to hold the note, to have an interest in the note and to have a security interest in the mortgage securing the note, all without becoming the mortgagee of record. With the amendments, the secured party may be in a better position to rely on section 9-607(b), as further clarified, in order to become the mortgagee of record and conduct a non-judicial foreclosure sale.

33 See 834 N.Y.S.2d 692, 695-96, 866 N.E.2d 1020, 1023-24.
34 § 8-102 Cmt. 13.
35 § 8-102 Cmt. 13 (new).
36 In re Commercial Money Center, Inc., 392 B.R. 814, 53 A.L.R.6th 657 (BAP 9th Cir. 2008).
37 UCC § 9-102 Cmt. 5.d.
38 UCC §§ 9-406(e) & 9-408(b).
39 See, e.g., Moore v. Wells Fargo Bank N.A., 2009 WL 820672 (Ind. App. 2009) (holding, under Indiana law, that notice that informed guarantor that creditor intended to sell excavator through public Internet auction Website satisfied location requirement in section 9-613(1)(e)).
40 UCC § 9-610 Cmt. 2 (new).
41 UCC § 9-613 Cmt. 2.
42 See also UCC § 9-308(e) (providing analogous rule for perfection).
43 UCC § 9-607(b).

Foreclosure Sale to Secured Party

Secured parties may wish to buy at their own private sales, but such purchases are not allowed unless there is a market to test the transaction.[44] However, this restriction is not enumerated among the debtor's rights (listed in section 9-602) that cannot be waived. As a result, some creditors have hoped that it might be possible for a debtor to allow the secured party to buy at its own private sale, by a waiver of the prohibition of purchasing at their own private sales. In the 2013 amendments, however, new commentary was added, disapproving of such a practice:

> Section 9-610(c) limits the circumstances under which a secured party may purchase at its own private disposition. Transactions of this kind are equivalent to "strict foreclosures" and are governed by Sections 9-620, 9-621, and 9-622. The provisions of these sections can be waived only to the extent provided in Section 9-624(b). See Section 9-602.[45]

If the secured party buys at foreclosure, the remedy is simply a strict foreclosure and must comply with the requirements in section 9-620, et seq. Without the debtor's agreement, such a sale wipes out the deficiency balance. The only reason this was not singled out in section 9-602 is because it was perceived to be equivalent to a strict foreclosure. Secured parties should be cautious in this area, lest they run into a penalty for violation of Part 6.

PRACTICE TIP:

Enforcement Issues—If a creditor's claim reflects a sale of the original loan, the new UCC rules may not suffice to remedy the many non-UCC problems that have produced claim litigation since the 2008 recession. If it reveals a credit resulting from its own purchase at its own private sale, that sale should be deemed a strict foreclosure and the insolvency advisor may argue that the creditor should not be allowed to assert a deficiency and might be subject to penalties for violation of Part 6 of Article 9.

TRANSITION RULES

As in 2001, the new law applies not only to future transactions but also to *existing* documentation on the effective date (generally July 1, 2013). However, there is a transition of up to five years for the amendment of financing statements that are rendered ineffective by the amendments. The most critical issue that this creates for filings arises from the changes in the proper name that must be provided for the debtor if the UCC-1 is to continue to be effective to be sufficient to perfect the security interest. New commentary explains the working of these transitional rules, on those important name standards that insolvency advisors must consider during the transition, with an example:

> On November 8, 2012, Debtor, an individual whose "individual name" is "Lon Debtor" and whose principal residence is located in State A, creates a security interest in certain manufacturing equipment. On November 15, 2012, SP perfects a security interest in the equipment under Article 9 (as in effect prior to the 2010 amendments) by filing a financing statement against "Lon Debtor" in the State A filing office. On July 1, 2013, the 2010 amendments, including Alternative A to Section 9-503(a), take effect in State A. Debtor's unexpired State A driver's indicates that Debtor's name is "Polonius Debtor." Assuming that a search under "Polonius Debtor" using the filing office's standard search logic would not disclose the filed financing statement, the financing statement would be insufficient under amended Section 9-503(a)(4) (Alt. A). However, Section 9-805(b) provides that the 2010 amendments do not render the financing statement ineffective. Rather, the financing statement remains effective—even if it has become seriously misleading—until it would have ceased to be effective had the amendments not taken effect. See Section 9-805(b)(1). SP can continue the effectiveness of the financing statement by filing a continuation statement with the State A filing office. To do so, however, SP must amend Debtor's name on the financing statement to provide the name that is sufficient under Section 9-503(a)(4) (Alt. A) at the time the continuation statement is filed. See Section 9-805(c), (e).[46]

Thus, a filing that is sufficient on July 1, 2013 will remain so until it lapses or until July 1, 2018, even if it is rendered ineffective by the rules in the 2013 amendments. However, given the confused state of the law in this area, courts that have not spoken to the individual-name issue may adopt the driver's license standard based on the guidance of the drafters in the 2013 amendments. That topic was extensively reviewed in Part I of this article. Illustrating the uncertainty in this area, courts have already gone in both directions on the issue.[47]

The author thanks Darlene Marsh, Burr & Forman, for her extremely valuable critique of these articles, and Kathi Allen, Stites & Harbison, for her assistance with the discussion of trusts.

***Lawrence R. Ahern III** is a member of Brown & Ahern and a Retired Partner at Burr & Forman LLP. His Nashville-based practice focuses on consulting with law firms and other professionals on commercial and bankruptcy issues, expert testimony, alternative dispute resolution, writing and teaching. Larry is a Fellow of the American College of Bankruptcy and the American College of Mortgage Attorneys, and a Director of AIRA.*

44 UCC § 9-610(c)(2).
45 UCC § 9-602 Cmt. 3 (new); see also UCC § 9-610 Cmt. 7.
46 UCC § 9-801 Legislative Note.
47 See, e.g., Bloom v. The Behles Law Firm, P.C. (In re Green), 2012 WL 5550767 (Bankr. D.N.M. Nov. 14, 2012) (holding "Ron," instead of "Ronnie J." insufficient, even though "Ron" appeared on driver's license); State Bank of Arthur v. Miller (In re Miller), 2012 WL 3589426 (C.D. Ill. Aug. 17, 2012) (holding debtor's name on driver's license sufficient; no "legal" name required).

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Fax: 541-858-9187
aira@aira.org
www.aira.org