AIRA Association of Insolvency & Restructuring Advisors

Journal

VOL. 28 NO.3 · SUMMER 2014

Mining for Value

Unique Challenges for Companies and Advisors in Today's Coal Industry

WHAT'S INSIDE

2014 DALLAS ENERGY SUMMIT

BELO MANSION & PAVILION
Thursday, September 18, 2014
2:30 - 7:30PM including Reception

Presented by
AIRA and the Southwest Chapter of CFA

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AIRA Association of Insolvency & Restructuring Advisors

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SOUTHWEST CHAPTER

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AIRA Journal is published four times a year by the Association of Insolvency and Restructuring Advisors, 221 Stewart Avenue, Suite 207, Medford, OR 97501.

Michael Lastowski - Editor
Forrest Lewis - Section Editor
Valda Newton - Assistant Editor

MATTHEW SCHWARTZ, CIRA
Bederson LLP

Greetings AIRA community! In this, my inaugural President's Letter, I want to start by acknowledging the Board of Directors and the staff of AIRA for their efforts. If you did not get a chance to speak with some of the staff who worked at the conference in Denver, you missed an opportunity to meet some very dedicated and talented people. I also want to acknowledge and thank Tony Sasso for his leadership as President these last two years. Tony and I have known each other since we were kids and were on our high school wrestling team together. One year behind him in school, I looked up to him as a role model even then and now gratefully follow his example as President. Finally, it is impossible to thank Grant Newton enough for his dedication to the AIRA and to the profession, and for the opportunities he has provided to me and so many other people.

For those folks whom I have not yet met (and who have read this far), my history with the AIRA started in 1994 (it was the AIA back then) at the annual conference in Washington. I actually still have the materials. I was so impressed with the organization and Grant that I began my pursuit of the CIRA designation the following year. In 2002 I helped start the Pre-Conference Toolbox sessions and in 2004 I became a member of the Board (Jim Lukenda was President!) and Treasurer shortly after that. Over the years I have met some of the brightest and most talented people in our profession at our conferences and events and have always been impressed by the caliber of our members. I always look forward to catching up with my friends at our events and hope to see everyone for many years to come.

For those who were not able to attend our June conference, you missed excellent panels, golf, excursions and watching the Rockies who lost, but what a fabulous stadium! You also missed the endless jokes about the mile "high" city.

Coming up during the next few months we are looking forward to:

- The NCBJ, October 8-11 in Chicago. Be sure to attend the opening reception which AIRA hosts every year, and pick up some swag from our sponsors. Also look for our breakfast program on Friday, October 10. They are always very informative and practical.
- Our annual NYC POR conference on November 17. As usual, we will have a full day of informative panels followed by cocktails and recognition of one of our distinguished judges for service to the profession.
- Valcon, February 25-27. Hope to see you in Las Vegas!

Also, as you read this, the planning for our 2015 Annual Conference in Philadelphia will be under way. I will keep you updated on all of our events in future letters.

As many folks know, last year the Board started the Grant Newton Educational Endowment Fund. Thanks to generous contributions from the Board and our members, we have raised over $60,000. Please note that there is now a line on your membership renewal where you can make a voluntary contribution. Please consider a gift as you renew your membership for the coming year. There is no minimum and all contributions are gratefully received.

In closing, I would like to share one story about my involvement in the AIRA. When I first started attending conferences I knew absolutely nobody. Over the years, as I got to know people, I felt welcomed and my suggestions and comments were taken seriously. If you get involved you will receive a much greater return on your membership than if you merely show up.

With that in mind, I am excited about this coming year, and hope to meet many more people. If you have any questions, comments or suggestions about anything at all regarding the AIRA, I would be more than interested in hearing from you by e-mail, by phone or best of all in person at one of our events.

TAKEAWAYS FROM THE ANNUAL CONFERENCE

GRANT NEWTON, CIRA
AIRA Executive Director

Although it has been almost two months since the conclusion of AIRA's 30th Annual Conference, I find myself continuing to reflect on, process, digest, synthesize and apply information and ideas presented throughout the conference. Below are a few thoughts and quotes that have among many others stuck with me, and that will continue to have an impact throughout the months ahead.

Gary W. Riley (Chairman, Ningbo Global Sourcing), in his presentation "China Operational Challenges—Beyond Macroeconomics" (Thursday, June 5, 12:00 pm) brought home some eye openers about the world's second largest economy:

> GDP growth is down 25% (but still high); manufacturing share of GDP growth is down nearly 40%; exports are down YOY; labor is no longer the lowest in the world; it is more difficult to keep good people; input costs like raw material and energy are generally higher in China than the USA or Mexico today; the Yuan has strengthened 30% over last 7 years; China has too much capacity in almost every industry – but not the right kind of capacity in most cases, and not enough value added in the manufacturing segment.

In "Strategies Used by Lenders and Loan Servicers," Grant T. Stein (Saturday, June 7, 8:30 am) gave us five cardinal rules to take away. Among them were:

> Lenders can handle bad news. What they hate are surprises. I've very rarely seen keeping a critical issue from a lender turn out well. They are far more likely to deal with a problem rationally and calmly if you tell them versus if they find it out from someone else ...

> Everything works if you let it … just not always the way that you want it to. A borrower taking a dogmatic approach on how to fix a problem is a recipe for disaster. Be flexible and open to changing circumstances. More often than not there is an opportunity hidden among the chaos, many times better than the original goal.

The panel of "Social Media and ESI" (Friday, June 6, 8:30 am) in a paper accompanying their presentation warned:

> "Tweet", "Re-Tweet", "Post", "Like", "History", "#Hashtag", metadata … these are just a few of the many newly coined phrases of the Information Age. Ten years ago, some of these terms did not even exist. Today these and other issues are directly impacting many businesses' decision making, marketing strategy, risk exposure and bottom lines. This is merely the tip of the 21st century social media and electronically stored information ("ESI") iceberg!

Mike E. O'Neal, JD, CPA, President Emeritus of Oklahoma Christian University, (Keynote presentation, Thursday June 5, 8:40 am) drew some startling conclusions based on industry data and over 40 years' experience in higher education including general counsel, VP of finance and administration, and vice chancellor of Pepperdine University. He quoted this prediction by Nathan Harden (The End of the University as We Know It, American Harvest, December 11, 2012):

> The higher ed revolution is coming. Just a few decades hence, half the colleges and universities in the United States will have disappeared . . . In fifty years, if not much sooner, half of the roughly 4,500 colleges and universities now operating in the United States will have ceased to exist. The technology driving this change is already at work, and nothing can stop it. The future looks like this: Access to college-level education will be free for everyone; the residential college campus will become largely obsolete; tens of thousands of professors will lose their jobs; [and] the bachelor's degree will become increasingly irrelevant; and ten years from now Harvard will enroll ten million students.

David Payne, CIRA, CDBV (President, D.R. Payne & Associates, Inc.) in "Valuation Standards and Their Application and Relevance in the Courts: Addendum" (Friday, June 6, 11:00 am), discussed the Board's objectives in developing AIRA's new valuation standards for distressed businesses:

> The Board has been highly cognizant of the nature and extent of financial advisory/consulting services provided by its members which should, and should not, be subject to the proposed Standards. The Valuation Standards Committee has incorporated numerous general and assignment-specific exceptions to the Standards which meet the Board's objectives of fostering best practices in the provision of advisory services that promulgate basic Standards of practice regarding distressed situations. These Standards should be followed by members of the AIRA who are practicing valuation services, and should generally not be in conflict with other professional standards the members may hold.

Brent Carlson, CIRA (Director, AlixPartners), shared his observations based on years' of experience in China (Thursday, June 5, 12:00 pm):

> Despite the challenges, China's best days lie ahead: in any scenario, China remains a top economy, key global economic driver, and a critical market to be in; in the short-to-medium term there will be winners and losers in each sector, offering attractive investment opportunities; Underperforming investments based on overly-high expectations will need to be addressed; Despite challenges in the short and medium term, China's best

days lie ahead, as long as reform continues.

The panel of "Issues in Media Restructurings" (Friday, June 6, 9:30 am) revealed this and other facts from a report by FTI Research and Analysis:

> 55% of all media companies that have exited bankruptcy since 1999 had at least some portion of debt equitized, leading to "involuntary ownership" by debt holders.

Tom Binnings (Partner, Summit Economics) in his luncheon Keynote Address "Fundamental Changes in the U.S. Economy: Future Outlooks" stated:

> Obamacare is only the [first] round. Dramatic increases in healthcare demand require efficiencies, rationing, and ultimately self accountability (Friday, June 6, 12:00 pm).

The presenters of "Role of the Financial Advisor in Ponzi Schemes" (Friday, June 6, 9:30 am) imparted this incisive observation:

> There are different agendas that a court-appointed fiduciary faces depending on whether the investor is a Net Winner or Net Loser: Net Winners typically do everything they can to protect the returns and redemptions paid to them. Net Losers desperately trying to recover something from their investment and the fiduciary is charged with obtaining this recovery for them.

Readers may find it helpful to refer to the materials and presentations from the conference, which were distributed at the Conference on USB drive and are also found at:

www.aira.org/conference/event/ANNCONF14/materials

AIRA Grant Newton Educational Endowment Fund

Established in June 2013, the Fund's mission includes furtherance of educational programs, scholarships and research in the areas of accounting, restructuring and insolvency. Contributions to the Fund are fully tax deductible. Membership renewals on AIRA's website now include a section for contribution to the Fund.

Contribute today at www.AIRA.org

UPCOMING COURSES

CIRA

Part 1:

Sep 08-10, 2014; New York, NY

Part 2:

Oct 14-16, 2014; San Juan, PR

Nov 19-21, 2014; New York, NY

Part 3:

Dec 08-10, 2014; Malibu, CA

Jan 13-15, 2015; San Juan, PR

CDBV

Part 1:

Nov 19-21, 2014; New York, NY

Part 2:

Sep 29-02, 2014; Malibu, CA

Part 3:

Oct 20-23, 2014; Chicago, IL

Dec 09-12, 2014; Malibu, CA

New schedule for 2015 including CIRA Online coming soon - see www.AIRA.org

Join AIRA @ the NCBJ

October 8 - 11, 2014

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AIRA Hosts

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Opening Reception

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For more information and registration for AIRA's Breakfast Program on Friday Oct 10, visit www.AIRA.org

Mining for Value:
Unique Challenges for Companies and Advisors in Today's Coal Industry

KEN HILTZ, ROBB MCWILLIAMS, JOE MAZZOTTI, and JAROD CLARREY
AlixPartners

The U.S. coal industry has long been an active area for corporate restructuring and transaction work. The bankruptcies of Patriot Coal and James River Coal, and recent coal-mining transaction activity, are but the latest chapters in a volatile industry legacy. Continued lackluster economic conditions are affecting global demand for metallurgical-grade coal. Meanwhile, a combination of abundant natural gas (thanks to the growth of hydraulic fracturing, or "fracking,") and new governmental alternative-energy mandates and environmental regulations have dampened the long-term outlook for thermal, or "steam," coal, which is used primarily in power generation and still accounts for over 90% of the coal consumed in the U.S. As shown in Figure 1, coal overall has declined from fueling over 50% of electricity generation in the U.S. in 2000 to about 40% today, and it is estimated that number will fall to below 40% by 2015. At the same time, pricing for steam coal has been weak since the Great Recession, and is expected to remain so over the next couple of years (see Figure 2).

Given this backdrop, what are some of the unique challenges for coal companies, including ones that might be heading toward chapter 11, and their advisors today? From a turnaround and restructuring perspective, there are many.

Complicated Liability Profiles

Coal businesses, like other mature industries, often have significant legacy liabilities, including health care, pension and environmental claims. Such legacy issues can create a difficult tangle of potential claims which require careful assessment and management in order to achieve a successful restructuring outcome, particularly claims involving industry-specific legal implications.

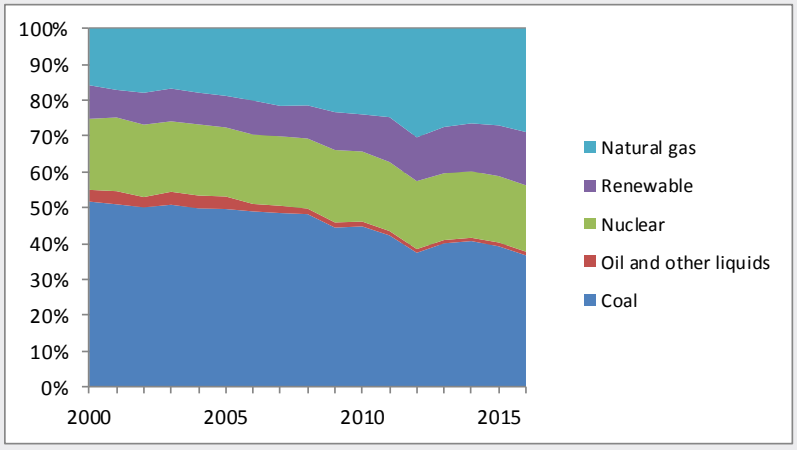
The coal-mining business has a long and complex legal history that contributes to its unique restructuring challenges. For instance, since as far back as 1891, federal legislation has addressed the issues of mine safety. Among other safety provisions, that first law included a provision prohibiting the employment of children under 12. Mining legislation has been reworked and updated multiple times in practically every decade since then, now leaving a complex web of legal requirements, restrictions and regulations covering not just mine safety but also environmental, miner-health and economic issues. The Federal Coal Mine Health and Safety Act of 1969, generally referred to as the Coal Act, was more comprehensive and stringent than any previous legislation and serves as the foundation for much of today's regulatory environment. It established mining-company obligations for an array of miner issues including coal workers' pneumoconiosis, better known as black lung disease, an occupational hazard specific to the coal industry – an obligation which is not dischargeable in a chapter 11 bankruptcy.

More recently, the Mine Improvement and New Emergency Response Act of 2006, known as the MINER Act, mandated emergency-response plans and more-secure closure of abandoned mines. The good news is that fatalities related to such issues have

FIGURE 1:

Share of U.S. Electric Generation by Fuel

Source: US Energy Information Agency, Annual Energy Outlook 2014



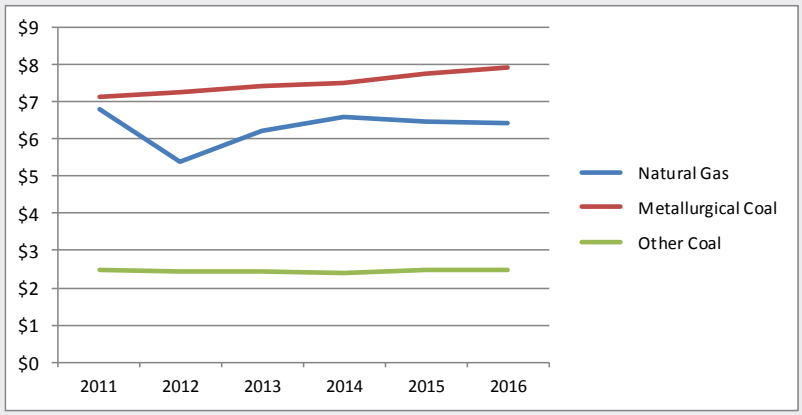


FIGURE 2:

Energy Prices per Million BTU (2012 US dollars)

Source: US Energy Information Agency, Annual Energy Outlook 2014

averaged fewer than 30 per year since 2006, down from more than 2,000 per year in the early 1900s. However, the increased cost of mine operations has added to companies' economic burdens.

Pension obligations in the coal industry can also create unique issues. In addition to typical, employer-specific pension obligations, often resulting from collective-bargaining agreements, many coal companies with long histories may also be party to a patchwork of pension plans including multi-employer pension plans (MEPs), which are created under collective bargaining agreements between multiple sets of local unions and employers. This includes the mining industry's MEP of 1974. MEPs are structurally difficult compared to conventional pension plans, in that a given company's obligation to the plan depends partly upon the financial strength of other participating employers involved with the plan, and on investment decisions made by trustees outside of any of the individual employers' control. Additionally, expected cash-flow savings from withdrawals from these plans must be weighed against potentially massive unsecured claims that could be asserted by the MEP in the event of withdrawal.

Environmental claims can also be particularly vexing for coal companies. A complex set of federal and state laws can modify or create additional requirements beyond those expected at the time mining operations were developed. Activist litigation has also been leveled against the mining industry in order to expand the reach of environmental regulations (e.g., targeting water run-off or restoration requirements), often resulting in unanticipated future costs for long-past mining activities. Such obligations are often difficult or impossible to impair. Further, environmental claims are inherently difficult to value in the industry since they are based on post-mining reclamation activity aimed at restoring mined areas (such as re-grading and re-planting) possibly occurring many years in the future and subject to changes in environmental regulations and requirements in that time.

Coal-mining companies are also susceptible to an industry specific type of contingent claim (i.e., a potential obligation based on the outcome of an uncertain future event) for what in the industry is called "subsidence," which occurs when surface land shifts due to a failure of underground mine supports. Subsidence may occur years after mining activity has ceased, and the potential damage (and, hence, the value of such claims) in the future is always a matter of speculation. Claims of this nature, which may be material and dilutive relative to the overall claim pool, often require negotiations among multiple creditor constituencies to find a resolution that adequately considers a range of estimated unknown future claims against the estate, relative to the interests of other creditors with fixed claims.

The mine-permitting process can also influence the outcome of a company's restructuring. Although permitting authorities do not enjoy any particular advantages in the traditional bankruptcy context, their influence over current and, importantly, future mining activities can give them substantive leverage. Permitting authorities, therefore, need to be considered in any plans to implement cost-reduction initiatives, mine closures, mine or business-unit sales (which require permits to be transferred), or many other traditional restructuring strategies. Permitting authorities also ensure that operators meet their obligations for past mining activities – or otherwise potentially compromise current and future permits. Consequently, environmental obligations can have a larger impact on a bankruptcy plan of reorganization than their statutory priority might indicate. Thus, in carrying out their role, the ability of authorities to issue, cancel and transfer permits engenders potentially powerful influence in determining a debtor's ability to implement a reorganization plan.

Contract Rejection/Assumption Complexities

In any chapter 11 case, the decisions regarding which contracts to reject and which to assume or assign can have a big impact on both the company's ultimate value and claims against it, and must always be undertaken with careful analysis. While no industry is without its unique types of commercial arrangements, we have found some common coal-industry contracts to be especially challenging to dispose of in a chapter 11.

Real-property leases often comprise the bulk of a coal company's assets in the form of coal reserves. Subject to the current 120-day deadline in chapter 11 for lease rejection-or-assumption decisions, analysis must be performed quickly. Meanwhile, however, leases in the coal industry may have been created over many years, may contain contract-specific financial arrangements for royalties (including overriding royalties, or "overrides"), and may have arguable integration issues relating to other contracts. Determining the value of such leases to the bankruptcy estate depends not only on the terms of the agreement, but on long-term mining plans and assumptions regarding things like pricing, demand, operating costs, expected legacy costs, and permitting requirements. Additionally, the location of reserves relative to existing mining and transportation infrastructure – as well as the area's geology and quality characteristics of the coal – can dramatically affect the value attributed to a given lease.

Even a coal company's vendor supply agreements may offer limited leverage for renegotiations in a chapter 11. The often-remote location of coal-mining operations can make it difficult or impossible to find and qualify alternative vendors in any reasonable period of time. Also limiting is the typical use of unique tools and mining equipment by location – often driven by different mining methods, which are in turn dictated by geologic conditions and economics. As a result, companies often have to rely on a limited universe of vendors for spare parts, maintenance needs, periodic re-builds, and other service needs. Additionally, certain commonly used items, such as roof bolters and safety equipment, are often specified in permitting schemes, meaning the operator cannot change specified items without going through a new approval process, along with the attendant effort, cost, and uncertain results. Usually, time is not on the side of the company if it hopes to squeeze additional value out of supply agreements.

Business-Planning Challenges

Forward-looking projections form the crux of any corporate restructuring, underpinning value and viability. The cliché that no one has a crystal ball holds true in any financial projection, and is no less so for the coal industry. The "commodity" nature of the business, however, compounds the normal difficulties in projecting long-term performance.

As a commodity, coal is subject to significant variations in pricing. Coupled with the high fixed costs of mining (including capital expenditures and investments in facilities, especially for underground mines, and the uncertainty of environmental and retiree costs), projected profitability and cash flow can swing substantially as a result of relatively small changes in pricing. Likewise, one's perspective on whether to continue operating mines, open new ones, or close existing ones can change dramatically depending on these pricing and cost assumptions.

However, not all coal output is fungible. The production at individual locations can vary considerably in terms of quality attributes, such as BTU (energy) per ton, ash content, and sulfur content. Customers typically require quality specs within a relatively narrow range, and may even refer to a specific mining operation from which the product is to be supplied. Consequently, coal from one mine may not readily be substituted for that of another. And, even where coal from different locations is similar enough to substitute, changing locations can drive significantly different transportation costs, while at the same time differences in mining methods, labor costs, and work rules can create very different marginal cost structures. Unlike factories that operate in discrete-manufacturing settings, consolidation opportunities can be very difficult to identify within one coal company's mining operations.

So, what in other industries might seem a relatively simple process turns out to be very challenging indeed in the coal business, requiring a deep understanding of things like cost structure, pricing, and demand, as well as a view of the macroeconomic – and even political – factors affecting the industry.

If history is any guide, restructuring in the coal industry is unlikely to end any time soon – especially given the advent of fracking, continuing regulatory pressures, and today's tepid economy. Therefore, companies and advisors alike must understand well this industry's unique characteristics – and, yes, the opportunities within those challenges. Those that do will be best-positioned not just to survive, but to thrive.

ABOUT THE AUTHORS

KEN HILTZ
Managing Director | AlixPartners
Based in Chicago, Ken has more than 30 years of experience in virtually all aspects of financial and operational restructuring, both as an advisor and interim officer, across a wide variety of industries.

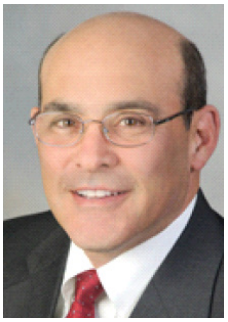
JOE MAZZOTTI
Director | AlixPartners
Based in Detroit, Joe has more than 25 years of experience advising clients across numerous industries in turnaround and financial restructuring situations.

ROBB MCWILLIAMS
Director | AlixPartners
Robb, based in Dallas, has more than 12 years of experience in restructuring including contingency planning and assisting clients in the process of developing and implementing PORs in a broad spectrum of industries.

JAROD CLARREY
Vice President | AlixPartners
Based in Dallas, Jarod has for the past seven years assisted a broad group of clients in bankruptcy preparation, reporting, and claims management.

For more information: www.alixpartners.com

MANNY KATTEN AWARD HONORS GRANT T. STEIN



The Manny Katten Award is bestowed annually on an individual selected by the Board who has demonstrated exceptional leadership, dedication and service to AIRA and the bankruptcy, restructuring and turnaround field. The award is named in memory of Manny Katten, Chairman of the first AIA Annual Conference and a founding Board Member. This year AIRA's Board of Directors selected Grant T. Stein, Esq., to receive the 2014 Manny Katten Award, which was presented at the annual banquet on June 5 at the Westin Denver Downtown.

So who is this southern gentleman, Grant Stein, anyway? Grant is a senior partner in the law firm of Alston & Bird in Atlanta. He has been with the firm for 31 years, a partner for the last 25. He is the former Chair of their Bankruptcy, Reorganization and Workout Group, where he continues to practice today. While he refuses to take any personal credit, one of the events occurring during his tenure as Chair of the practice was winning the Enron engagement, which I understand is the largest client in the firm's history. He is a Fellow of the American College of Bankruptcy, Chair and past president of the Southeastern Bankruptcy Law Institute, and is identified as a top practitioner in Chambers USA: America's Leading Lawyers for Business, The Best Lawyers in America, and Super Lawyers magazine. Some recent high profile clients he has served include Anderson News, Sonicblue and Alabama Aircraft. He has amassed extensive bankruptcy and litigation experience dealing with valuation matters and the many questions that must be addressed. In 2009, he co-authored a book with Ian Ratner and John C. Weitnauer entitled *Business Valuation and Bankruptcy*, published by John Wiley.

Going back in time just a little bit... Grant's passion for our business started at an early age. Going back to 1917, his grandfather was an Industrial Auctioneer. Grandpa started a company that is now known as Rosen Systems. That business continued in the family for generations and in the 1930s became a court appointed Auction Company. Around 1970 at the age of 13, Grant found himself hanging out in bankruptcy court watching bankruptcy judges do their work involving asset auctions and other matters. This led to Grant working in the family business at age 16.

After finishing high school and an undergraduate degree at Emory in 1978, Grant decided to go to law school. Upon hearing of this decision, his father (a "lived through the depression kind of guy"– like my own father) was thinking thoughts that I can relate to, like "why would you waste your time becoming a lawyer when we have a great business here?" Of course in the end, based on Grant's accomplishments, I'm sure his father would agree that it was a great decision after all.

Grant received his law degree from the University of Georgia in 1981. From 1981 to 1983, Grant clerked for Federal Bankruptcy Judge Homer Drake in the Northern District of Georgia. Grant made it a point to say what a blessing this was and to stress how much he learned from Judge Drake. As many of you would know, Judge Drake's work has been very important to the history of Bankruptcy law in the U.S. and the way it is practiced today. As you can imagine, Grant had quite a mentor for his Clerkship.

Then of course, there's Grant, the family man: During Grant's journey through law school and clerkship, he met his future wife, Janet (also in law school). They married in January 1983, after which Grant finished his clerkship and accepted an offer with Alston & Bird, all in the same year. And so he began a 31-year journey blessed with a lasting marriage, raising 3 children, and a career job!

As to philanthropic activities, one cause for which he worked passionately perhaps came to a sad ending because it closed its doors a couple years ago; but, one could say the organization had fulfilled its purpose. That organization was the Butler Street YMCA, which dated back to 1894 and was a minority-only entity during the Civil Rights era in the '60s. When the organization ran into financial difficulties, Grant stepped up to provide extensive pro bono work, playing a critical role to help it through difficult times for years.

Some of Grant's contributions to the AIRA: Grant's involvement with the Association goes back to the early '90s, when it was known as the AIA (Association of Insolvency Accountants). One of my colleagues, Tim Ely in Atlanta, recruited Grant to help him put together a valuation program. The idea was to invite a mix of participants (lawyers, auctioneers, advisors and so on). While this idea seemed to go against the conventional wisdom that there was not a big enough audience for this type of program, they stuck with it and ended up having a very successful regional program attended by close to a hundred professionals.

Grant joined the AIRA Board in the mid-1990s; at the time, the only other lawyer on the Board was his fellow partner, Neal Batson. Even though Grant was a lawyer, what he really enjoyed about the AIRA was the financial advisory side of the business. In that vein, he always reminded us to maintain our focus on the AIRA's mission and purpose, to focus on the accounting / business / advisory side of restructuring and leave the true legal focus to those organizations that complement AIRA so well, like the ABI. Grant has been a great supporter for the better part of 20 years, serving as president from June 2008 to June 2010, and then as chairman until June of 2012.

Some personal observations regarding Grant's leadership style as AIRA President: He was always confident, had a positive attitude and showed steady leadership, making it all look easy as he provided two solid years of direction and vision. In addition, he has been active for many years on the Board and made many other significant contributions, such as sponsorships, participating on panels and committees, identifying an excellent replacement (Will Sugden) when he stepped down from the Board. Currently, Grant continues to attend meetings and functions and AIRA benefits greatly from his continued support.

ANTHONY V. SASSO, CIRA
Deloitte Financial Advisory Services LLP

2014 ZOLFO COOPER - RANDY WAITS AWARDS

Medals and Certificates of Distinguished Performance were presented at the Annual Banquet to candidates who earned the top composite scores for all three parts of the CIRA exam completed by end of the previous year.

GOLD MEDAL—SPENCE SHUMAY, CIRA

Spence received his CIRA certification at the Annual Conference along with his Gold Medal Award. He has been a member of AIRA for over 20 years. Spence founded Stonebridge Accounting & Forensics, LLC, in Atlanta in 1987. He received a B.S. in Accounting from BYU in 1978 where he was a presidential scholar and graduated Summa Cum Laude.

Spence started working at the age of 6 in his family's drug store; to support his social life he also worked in the hay and oil fields. He served as a senior manager with KPMG and has been an adjunct professor for John Marshall Law School in Atlanta. During the mid-80's he was the #1 nationally rated instructor for Becker CPA Review; he has also taught a bankruptcy tax concepts course for the IRS Special Procedures Group. Spence loves spending time with his wife, their children and grandchildren.

SILVER MEDAL—PATRICK FODALE

Pat received a Bachelor's degree, as well as a Master's degree in Accounting from the University of Michigan in 1985. He is a Managing Director with Loughlin Management Partners & Company in New York. Prior to joining Loughlin in 2003, he spent eight years as a restructuring CFO, specifically recruited by companies experiencing financial distress, including Color Tile, HomePlace and United Road Services. Prior to that, he was with Arthur Andersen's Corporate Recovery Services Practice.

Pat has been happily married to Lori for 22 years and has a daughter, Hannah, currently in high school. He enjoys golf, skiing and attending rock concerts (especially when he can drag his daughter along). Pat enjoys the marine aquarium hobby and maintains a couple of "reef" focused aquariums in his office and home.

BRONZE MEDAL—CHRISTOPHER HANSON, CIRA

Chris received a BA from the University of Pennsylvania in 1993. He went on to receive an MBA from the Wharton School of Business in 2003. He has been with Navigant Consulting, Inc., since 2002 and is currently a Director. Prior to joining Navigant, he was a senior manager at Arthur Andersen.

Chris is married to Chermei Wong-Hanson. They have family in Boulder, CO, and are prone to attending conferences in Denver because Chris will spend as much time as possible climbing up, skiing down and biking through the mountains. He is a certified pilot and has been working on finishing his instrument rating.

CERTIFICATES OF DISTINGUISHED PERFORMANCE

MICHAEL CANALE, CIRA, *Canale Advisors*

SERGEI CHERNYSHOV, *ISE*

SARA SOONG, CIRA, *Hunt Consolidated, Inc.*

THOMAS STUDEBAKER, CIRA, *AlixPartners*

BRADLEY VAN ETTEN, *Hays Financial Consulting*

Section 503(b)(9) Claims: Recent Chapter 11 Cases in the Middle Market Grocery Sector

JEAN HOSTY
Piper Jaffray & Co.

Bankruptcy Code section 503(b)(9) was adopted as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") to provide additional protection to suppliers of goods by allowing them to assert an administrative expense claim for the value of goods sold and delivered to a company within 20 days of the company's bankruptcy filing ("503(b)(9) claim").

Due to the fact that 503(b)(9) claims are considered an administrative expense, a debtor must address them in order to successfully reorganize. While this can increase the burden on a debtor in terms of liquidity and uses of funds, proactively addressing these claims can allow a debtor to garner significant leverage with its critical vendors and go forward as a reorganized business with improved vendor terms.

Two recent Chapter 11 cases in the middle-market grocery sector, C&K Market and Mi Pueblo San Jose, demonstrate two different programs for 503(b)(9) claims. The circumstances of each case—particularly the pre-filing preparation, relationship with the prepetition secured lender, and liquidity picture—all greatly impacted the debtor's ability to successfully enact their 20-day vendor program and successfully reorganize.

Provisions of Section 503(b)(9)

BAPCPA's 503(b)(9) addition granted administrative expense priority for the value of goods sold to in the ordinary course of business and received by a debtor within 20 days of the bankruptcy petition date. While this change greatly benefitted vendors, or at least those who correctly and timely assert their claims, it created a somewhat mixed circumstance for debtors.

Critical to a debtor's ability to reorganize is the ability to procure necessary goods in the days leading up to a Chapter 11 filing as well as post-petition. This category of administrative claim incentivizes vendors to continue to provide goods, as it provides that they will generally receive payment ahead of prepetition unsecured creditors. Simply put, unless a Chapter 11 case is administratively insolvent, these vendors must receive some form of payment for their goods, and it is therefore a relatively low-risk proposition for a vendor to provide goods to a potentially distressed customer in order to maintain an ongoing customer relationship.

However, from a debtor's perspective, a higher amount of administrative priority claims creates an increased burden on reorganization, as a plan cannot be confirmed without the consent of all administrative expense claimants. This provides leverage to 503(b)(9) claimants and thereby forces debtors hoping to reorganize to find a way to address 503(b)(9) claims. For some debtors, how 503(b)(9) claims are handled can mean the difference between successfully reorganizing and administrative insolvency.

No uniform procedural rules exist for the assertion of 503(b)(9) claims. For debtors, understanding the venue and local rules and case-by-case history (and which precedent is most relevant to the debtor's size and relevant business), and planning accordingly, is critical to developing a 503(b)(9) program. Early in Chapter 11 cases, debtors often seek to establish immediate discretionary authority to pay 503(b)(9) claims, as well as an exclusive process for asserting, reviewing, allowing, and barring them. Strategically, debtors can benefit from this discretionary authority by incentivizing favorable arrangements with vendors, including securing advantageous terms, reduction in claim amount, or acceptance of a desired reorganization plan.

Two recent grocery cases, C&K Markets and Mi Pueblo San Jose, highlight different styles of 503(b)(9) claim treatment, and demonstrate two options to consider for vendor programs, depending on the debtor's circumstances in the weeks leading up to a filing.

C&K Market, Inc.

C&K Market, Inc. ("C&K") is a privately owned regional supermarket company based in Brookings, Oregon. C&K experienced an accelerated decline in sales in 2012-2013 due to the impact of competition from new Walmart supercenters. As a result of the decline in cash flow and a default under its loan agreements, C&K filed Chapter 11 in November 2013. Key near-term priorities included obtaining debtor-in-possession financing, exiting the pharmacy business, closing underperforming stores, selling excess real estate, and using proceeds to lower senior

leverage to market levels. Enacting these initiatives was critical to developing a confirmable plan of reorganization for C&K.

C&K's Chapter 11 filing was carefully planned by the debtor and its advisors, and negotiations with various creditor groups took place in advance of and up to the filing in order to minimize business disruption and clear the path to a successful reorganization. Critical to all parties was ensuring sufficient liquidity in the seasonally less-profitable winter months after the petition date. This required debtor-in-possession financing as well as a successful 503(b)(9) program, as there was not enough cash or borrowing availability to fund a significant amount of vendors' reducing terms or demanding cash on delivery.

To address this, C&K filed as a part of its first day motions a Motion for Authority to Pay 503(b)(9) Claims, requesting a hearing on an expedited basis. C&K estimated approximately $6 million of 503(b)(9) claims existed as of the petition date (excluding any PACA claims, which were treated separately). The motion argued that ensuring the continued and timely delivery of goods was critical to the debtor's operation, and helping the debtor access post-petition trade credit would be greatly facilitated by giving the debtor the authority, but not direction, to pay any undisputed 503(b)(9) claims.

This 503(b)(9) program achieved two key goals for the debtor. First, it gave the debtor the exclusive authority to pay undisputed 503(b)(9) claims on a discretionary basis. Second, it conditioned payment of these claims on each vendor providing pricing and payment terms equal to or better than those provided prepetition. This combination gave the debtor significant negotiating leverage with vendors, who could be incentivized to continue extending credit and pricing by obtaining the debtor's stipulation to claim amount and expedited payment. Especially in a Chapter 11 case without a prepackaged plan of reorganization or sale, certainty in amount and timing of claim payment was a strong incentive to ensure vendor cooperation.

For C&K, this vendor program proved highly successful, and ensured the debtor had sufficient liquidity to successfully operate through the seasonal downturn, refinance, and reorganize. C&K's plan of reorganization was confirmed on June 30, 2014 and it is expected to emerge from Chapter 11 in August 2014.

A key element of the success of this program was the ability to plan ahead in cooperation with the key parties-in-interest, and obtain the necessary discretionary authority from the bankruptcy court on an expedited basis.

Mi Pueblo San Jose, Inc.

Mi Pueblo San Jose, Inc. ("Mi Pueblo") is a privately owned regional, Hispanic-oriented supermarket chain based in San Jose, California. Mi Pueblo experienced rapid growth from its inception through an Immigration Customs Enforcement Audit (I-9 Action) of its payroll records in August 2012. The impact of this audit was significant employee turnover (approximately 80% of employees) and a resulting increase in labor costs, as well as the loss of experienced critical employees. Ongoing impact to profitability from this audit, as well as general decline in market share for traditional grocery stores, resulted in an impasse in negotiations with Mi Pueblo's primary secured lender, which, along with litigation with a former landlord, led to a Chapter 11 filing in July 2013.

Like C&K, Mi Pueblo filed a motion authorizing payment for 503(b)(9) and establishing a bar date for claims to be considered on an expedited basis as a part of its first day motions. However, unlike C&K, Mi Pueblo did not establish these 503(b)(9) claim payments as contingent upon extending equivalent price and credit terms to those provided prepetition. Mi Pueblo also had a larger and more diverse base of critical vendors than C&K, complicating its ability to deal with vendors in a uniform manner. Most importantly, the dispute with the prepetition secured lender, as well as the precipitousness of the filing, prevented Mi Pueblo from having a pre-negotiated plan for 503(b)(9) treatment mutually agreed to as a use of cash collateral. Without the support of the prepetition secured lender, the debtor was unable to use payment timing as incentive to secure favorable vendor terms.

Without the leverage of a program to get 503(b)(9) claims paid, Mi Pueblo was able to establish trade credit only on a one-off basis with vendors based on established business relationships. As uncertainty remained with vendors in the weeks following its Chapter 11 filing, Mi Pueblo found preserving trade credit from vendors to be difficult, and lost significant operating liquidity as a result. Due to this inability to pay claims in the normal course, as Mi Pueblo approached filing a plan of reorganization, approximately $9 million of 503(b)(9) claims were outstanding and needed to be provided for.

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Jean Hosty is a VP and member of the Capital Advisory Group at Piper Jaffray. She has over 7 years of transaction experience and is involved in a full range of investment banking activities. Her industry experience includes consumer, building products, industrials, healthcare, and agriculture. Piper Jaffray is serving as financial advisor to US Bank with respect to C&K Markets and investment banker to Mi Pueblo San Jose.

After running an extensive financing and sale process, the debtor determined the highest and best bid in the form of a two step debtor-in-financing and exit financing through a plan of reorganization. Given this winning bid's valuation and other cash uses, there was not sufficient liquidity in the plan to pay 503(b)(9) vendors claims at exit. However, once the debtor-in-possession financing was in place, the funding of which resolved the dispute with the prepetition secured lender by paying their claim in full, the debtor was able to work with the unsecured creditors committee and its advisors to develop a solution that worked for all parties. In this case, these negotiations were further incentivized on all sides by timing, as the debtor had to exit Chapter 11 by a certain date to secure exit financing and pay required increases in cash to secure a letter of credit to support the debtor's workers' compensation insurance policy.

As a part of its plan of reorganization, Mi Pueblo's vendors' allowed 503(b)(9) claims received a small cash distribution from a pre-negotiated escrow provided by the exit financing lender, as well as some combination of unsecured A and B Notes, the mix of which was determined by credit terms provided post-petition and subject to certain conditions. The A Notes accrue interest at 10% and have a maturity of three years from the maturity date, whereas the B Notes accrue interest at 8% and have a maturity of three years from the maturity of the A Notes. In addition, these vendors were invited to participate in a Trade Credit Program to establish credit terms and supply agreements on a case-by-case basis. Critical to this arrangement, vendors were given the option to pay down their notes outstanding using cash generated post-petition by extending credit terms. In this way, Mi Pueblo was able to preserve sufficient liquidity to reorganize, as well as incentivize the extension of post-petition trade credit and avoid objections to the plan from allowed 503(b)(9) claims.

Conclusion

While both of these cases resulted in successful plan confirmation, the facts and circumstances of each case drove the set of options available to the debtor. While the businesses operate in generally the same segment, size, and region, the amount of time to prepare for a filing, as well as the relationship with the prepetition secured lender, largely drove their respective results. For debtors, the more time there is to work out a mutually acceptable vendor program, the stronger the ability to avoid unnecessary disputes, successfully preserve liquidity, and reorganize. In both situations, the debtor was able to take a potentially burdensome liability and use available incentives to create value for the reorganized business in the form of increased liquidity, improved credit terms, or go-forward pricing. And while generally viewed as an added protection for vendors, the revision of the Bankruptcy Code to nclude 503(b)(9) claims with all administrative priority claims is not without benefit to debtors if handled correctly.

More information at www.piperjaffray.com

Where Will Stern v. Marshall End Up?
Arkison Is Not the Final Word

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Two years ago AIRA Journal published an article by the author which posed the question, where will *Stern v. Marshall*, 131 S.Ct. 2594 (2011), end up? The article focused on practical aspects of *Stern* such as whether it was simply a return to the *summary/plenary* jurisdiction that recognized the limits in the judicial authority of the Bankruptcy Judge where a litigant has not filed a proof of claim: See *Katchen v. Landy*, 382 U.S. 323 (1966); *Stern*, 131 S.Ct. at 2620–21 (Scalia J., concurring). Nothing in *Stern* limited the Bankruptcy Court's ability to consider relief from the automatic stay, valuation, use of cash collateral, post-petition lending, discharge, dischargeability, exemptions, plan confirmation, rejection of union contracts, modification of retiree benefits, and component issues under 11 U.S.C. §§ 362, 363, 364, 506, 522, 523, 727, 1225, 1325, 1113, 1114, and 1129, as examples.

There are very real questions that remain after the Supreme Court's June 9, 2014 decision in *Exec. Ben. Ins. Agency v. Arkison, Ltd.*, 134 S.Ct. 2165 (2014), and the Supreme Court has granted *Certiorari* in *Wellness Int'l. Network, et. al. v. Sharif*, Case No. 13-935 (July 1, 2014) on two issues. The first issue is whether a Bankruptcy Court has the judicial authority to determine what is property of the estate when the issue is based on state law. The language of the *Questions Presented* on which *Certiorari* was granted was:

> 1. Whether the presence of a subsidiary state property law issue in a 11 U.S.C. § 541 action brought against a debtor to determine whether property in the debtor's possession is property of the bankruptcy estate means that such action does not "stem[] from the bankruptcy itself" and therefore, that a bankruptcy court does not have the constitutional authority to enter a final order deciding that action.

Petition for Writ of Certiorari at ii, *Wellness Int'l Network* (2004) (No. 13-935).

The next issue is whether consent, implied or actual, allows for the exercise of judicial power by the Bankruptcy Court. The explicit language of the *Questions Presented* on which *Certiorari* was granted was as follows:

> 3. Whether Article III permits the exercise of the judicial power of the United States by the bankruptcy courts on the basis of litigant consent, and if so, whether implied consent based on a litigant's conduct is sufficient to satisfy Article III. *Id* at III.

In *Sharif*, the debtor, Richard Sharif, filed a voluntary Chapter 7 petition. A complaint was filed with four counts under 11 U.S.C. § 727 objecting to Sharif's discharge, and a fifth count seeking a declaratory judgment that a trust was Sharif's alter ego. Ultimately, a default judgment was entered by the Bankruptcy Court as a sanction for failure to provide discovery responses. The Seventh Circuit affirmed the entry of the default judgment on the discharge questions, and vacated the default judgment on the alter ego claim against the trust.

The Seventh Circuit focused on the fact that the alter ego claim in *Sharif*, while nominally called by the Petitioner a Section 541 *property of the estate* question, dealt with the Soad Wattar Trust, a non-party, non-debtor (though the debtor Sharif was the trustee of the Trust), and non-filer of a proof of claim, and on the fact that an alter ego determination is a matter of state law and not of bankruptcy law. The two issues to be decided by the Supreme Court in *Sharif* are important issues, though the context in which they are presented may be difficult from which to draw broad rules.

The Supreme Court's decision in *Arkison* determined, among other things, that core proceedings over which the Bankruptcy Court cannot exercise Article III judicial authority could be the subject of the submission of proposed findings of fact and conclusions of law for *de novo* review by the Article III District Court Judge. The Supreme Court expressly noted that this ruling eliminated the "statutory gap" in 28 U.S.C. §157(c)(1) by treating claims subject to Constitutional Stern judicial limitations as non-core. As the Supreme Court indicated: "The statute permits *Stern* claims to proceed as non-core within the meaning of §157(c)." Nonetheless, the questions that remain are substantial, and some will be decided in *Sharif*.

If, in a non-core or *Stern* matter, the parties do not consent to the entry of final orders by the Bankruptcy Judge under Bankruptcy Rule 7012 and 28 U.S.C. § 157(c)(2), what happens if a motion to dismiss is filed and denied by the Bankruptcy Court? The Bankruptcy Court has authority under *Arkison* to submit proposed findings of fact and conclusions of law. Similarly, Bankruptcy Rule 9033 does not distinguish between orders granting or denying a motion entitling the parties to *de novo* review in the District Court. Certainly, any order granting a motion is entitled to such review, and an order denying such a motion should presumptively be entitled to such review. What about discovery motions which

are not dispositive? Bankruptcy Rule 9033 does not differentiate between substantive final rulings and interim rulings in entitling the party to review by an Article III Judge, and its incorporation by reference of 28 U.S.C. § 157(c)(1) only require that a final order be entered by the District Court, not that the order being reviewed itself be a final order. Bankruptcy Rule 9033 and 28 U.S.C. § 157(c)(1) are included here and highlighted in relevant part:

RULE 9033. REVIEW OF PROPOSED FINDINGS OF FACT AND CONCLUSIONS OF LAW IN NON-CORE PROCEEDINGS

(a) SERVICE. ***In non-core proceedings heard pursuant to 28 U.S.C. §157(c)(1)***, the bankruptcy judge ***shall file proposed findings of fact and conclusions of law***. The clerk shall serve forthwith copies on all parties by mail and note the date of mailing on the docket.

(b) OBJECTIONS: TIME FOR FILING. Within 14 days after being served with a copy of the proposed findings of fact and conclusions of law a party may serve and file with the clerk written objections which identify the specific proposed findings or conclusions objected to and state the grounds for such objection. A party may respond to another party's objections within 14 days after being served with a copy thereof. A party objecting to the bankruptcy judge's proposed findings or conclusions shall arrange promptly for the transcription of the record, or such portions of it as all parties may agree upon or the bankruptcy judge deems sufficient, unless the district judge otherwise directs.

(c) EXTENSION OF TIME. The bankruptcy judge may for cause extend the time for filing objections by any party for a period not to exceed 21 days from the expiration of the time otherwise prescribed by this rule. A request to extend the time for filing objections must be made before the time for filing objections has expired, except that a request made no more than 21 days after the expiration of the time for filing objections may be granted upon a showing of excusable neglect.

(d) STANDARD OF REVIEW. ***The district judge shall make a de novo review upon the record or, after additional evidence, of any portion of the bankruptcy judge's findings of fact or conclusions of law to which specific written objection has been made in accordance with this rule.*** The district judge may accept, reject, or modify the proposed findings of fact or conclusions of law, receive further evidence, or recommit the matter to the bankruptcy judge with instructions.

28 U.S.C. §157(c)(1) provides as follows:

157(c)(1) A bankruptcy judge may hear a proceeding ***that is not a core proceeding*** but that is ***otherwise related to a case under title 11***. In such proceeding, the bankruptcy judge ***shall submit proposed findings of fact and conclusions of law to the district court, and any final order or judgment shall be entered by the district judge*** after considering the bankruptcy judge's proposed findings and conclusions and after reviewing de novo those matters to which any party has timely and specifically objected [emphasis added].

Of course, in considering a motion to dismiss or even a motion for summary judgment, there can be no "finding of fact" because the issues are considered pure issues of law. Does that mean that the Bankruptcy Court's determination to deny a motion to dismiss somehow escapes judicial review under Bankruptcy Rule 9033? Is the only way to obtain judicial review by interlocutory appeal under Bankruptcy Rule 8003? Why should it be the case that on a dispositive, or non-dispositive motion, the judicial authority of the Bankruptcy Court under *Stern* and *Arkison* may be broader than what a United States Magistrate is statutorily authorized to do? This is because a U.S. Magistrate is barred from having delegated to it for decision certain matters such as motions to dismiss and for summary judgment. 28 U.S.C. §636(b)(1)(A) provides in relevant part that "a judge may designate a magistrate judge to hear and determine any pretrial matter pending before the court, except a motion for injunctive relief, for judgment on the pleadings, for summary judgment, to dismiss or quash an indictment or information made by the defendant, to suppress evidence in a criminal case, to dismiss or to permit maintenance of a class action, to dismiss for failure to state a claim upon which relief can be granted, and to involuntarily dismiss an action." Is a Bankruptcy Court determination on any issue in a non-core matter absolutely entitled to review by the Article III District Court under Bankruptcy Rule 9033 under the plain language of the rule and applicable principles of statutory construction and law?

What is the best way to address all of the substantive and procedural questions and uncertainties discussed above, and that are going to be raised by litigants but are not discussed above? Is it to amend the statutes and rules to create a modified system to deal with the issues that are going to be raised? Is it to return to a simplified system of summary and plenary jurisdiction that existed prior to enactment of the Bankruptcy Reform Act of 1978? Is it to make all Bankruptcy Judges Article III appointments to eliminate the jurisdictional infirmities that have plagued the bankruptcy system for innumerable years and thus to recognize the true value of one of the most significant economic forums to individuals and business that exists in the United States? Or, is there another approach to take? In conclusion, this Article does not answer the questions posed above. The legal and policy issues are complex. It is simply noted that *Stern*, *Arkison* and *Sharif* are not the end of the story by any measure.

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Former chair of Alston & Bird's Bankruptcy, Reorganization & Workouts Group, Grant's diverse practice includes the representation of debtors, secured and unsecured creditors, creditors' committees, and fiduciaries in difficult out-of-court workouts, debt restructurings, bankruptcy cases and financial transactions throughout the U.S. and internationally. He also regularly represents officers, directors and other parties in bankruptcy litigation of all kinds. Mr. Stein is a past president of AIRA and member of its Board of Directors; Fellow of the American College of Bankruptcy, serving on its Board of Directors and Board of Regents (2007-2011) and as co-editor of College Columns.

CIRAs, Cost Accounting, and Charlie

PROF. JACK F. WILLIAMS, PHD, JD, CIRA, CDBV
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I have a confession to make: I love cost accounting. I recall the first day in my cost accounting class when the teacher, whom I would come to adore, introduced the class with the statement, "Now that we have that rather peculiar institution, financial accounting, under our collective belts, it's time to turn to a subject that actually has utility." Cost accountants are like that.

What attracted me to bankruptcy accounting and financial advisory work is its focus on costs, claims, and debts (the latter two labels by which we know many costs in bankruptcy), in an effort to understand a business, its profits, and its profitability. In this article, I would like to introduce you to an interesting connection across several subjects, including bankruptcy accounting and financial advisory work, cost accounting, and evolution. From my prior writings, you will see it as a common approach I undertake to place accounting and finance in an appropriate historical context.

The CIRA Designation

No doubt, obtaining the Certified Insolvency and Restructuring Advisor (CIRA) certification is challenging. In addition to the experience and education requirements, a candidate must take and pass a challenging three-part examination. given over a three-week period. The examination covers an eclectic range of topics, reflecting the broad range of accounting, finance, tax, and valuation issues that a CIRA will confront in restructurings, financial distress, and bankruptcy.

A perusal of the CIRA Body of Knowledge stands witness to the breadth and depth demanded to obtain this certification. I just want to highlight one area that has continued to fascinate me academically and professionally: – profitability studies. As a CIRA, we have mastered various profit and profitability assessment techniques. These techniques include four-wall analysis in retail engagements, manufacturing cost flows, cost-volume-profit relationships, breakeven analysis, development and critique of costing systems, customer profitability assessments, budgeting and variance management, and pricing. These tools rests on a nuanced appreciation and understanding of cost behavior and cost classification, including an understanding of direct costs, indirect costs, cost drivers, variable costs, fixed costs, and contribution margins.

It should not surprise you the reader that companies in financial distress often do not understand their costs. Their cost systems are non-existent or antiquated. Often, there are few identified direct costs and indirect costs, including overhead, which are allocated to too few cost pools with very little relevance to the actual fundamental activities that produce the products or services that generate revenue, obscuring the total costs (variable and fixed) incurred to generate revenue. Bad cost numbers lead to bad profitability numbers. Without a handle on costs, a business is flying blind. That may be just fine when the financial weather is clear, but as soon as the financial storm approaches, well . . . not so much. That leads us to a short history of accounting, the subject of a new book by Jane Glesson-White, entitled *Double Entry: How the Merchants of Venice Created Modern Finance.*

A Brief History of Accounting

Glesson-White provides a fascinating account of the development and influence of double-entry bookkeeping. By now, most of us know the revolution launched by double-entry accounting. Upon his arrival in the Fifteenth century in cosmopolitan Venice, Luca Pacioli became enchanted with the Venetian merchants' development and use of double-entry accounting, bookkeeping the Venetian way. Pacioli melded the Venetian system with systems of the ancient Greeks and Arabs; he reformulated the Venetian system into an elegant approach still used to this day.

What Glesson-White adds to the story is nothing short of eye opening and marvelous entertainment. She begins with Pacioli's guarantee, found in his 1494 treatise, that if a merchant follows the system, he will know "all about his business and will know exactly whether his business goes well or not" (Glesson- White 93). Pacioli envisioned double-entry accounting as "nothing else than the expression in writing of the arrangement of [a merchant's] affairs" (*id*. at 93). His use of the trial balance, which allowed for merchants to check their books for mistakes, led to association of Pacioli's system with "good bookkeeping" and best practices (*id*. at 124). Along with the elegance is of his refined Venetian accounting system, Pacioli benefited from the arrival and use of the Gutenberg press. His treatise was one of the first to benefit through wide dissemination made possible through by the printing press. By the Eighteenth Century, commentators sang the praises of the Venetian system developed by Pacioli for its insights on profits and losses and the information it provided a merchant in decision making.

> Book-keeping by Double Entry, or what is commonly called the Italian method of Book-keeping, is the art of keeping our accompts in such a manner, as will not only exhibit to us our neat gain or loss upon each article we deal in, by which we are instructed what branches to pursue, and which to decline; a piece of knowledge so very essential to every man in business, that without it a person can only be said to deal at random, or at best can be called but guess'd work (*id*. at 127; (quoting Wardhaugh Thompson, *Accomptant's Oracle of 1777*).

In fact, by the Eighteenth Century, the double-entry system had become so pervasive at "taking stock" of one's business affairs, and thereby setting or righting a course of business, that it became a part of popular culture, memorialized in such novels as Daniel Defoe's *Robinson Crusoe*, published in 1719. Glesson-White's treatment of how the ways double-entry bookkeeping influenced popular culture and government provides a stunning perspective on the importance of the Venetian system. What captured my attention, however, is how the industrialists of the Nineteenth Century employed double-entry bookkeeping as they built their empires, much like their merchant predecessors in Fifteenth Century Venice had in launching the Renaissance.

Charlie

If Fifteenth Century Venice witnessed the rise of the merchant and the mercantile exchange, late Eighteenth and Nineteenth Century England witnessed the rise of industrialists and the capitalist revolution. At the heart of both revolutions, according to Glesson-White, rested double-entry bookkeeping. With the new world of factories, accountants "transformed a mere system of recording exchanges into a method of managing and controlling business" (*id*. at 136).

> The first signs that double entry bookkeeping would be equal to the task of monitoring and directing this new industrial world of factories, wage lablour and large-scale capital investment were found in the north of England, in the pottery works of Her Majesty's potter, Josiah Wedgwood (1730-1795) – a factory called Etruria, named, by chance, after the ancient Italian region home to Pacioli's Sansepolcro (*id*. at 136).

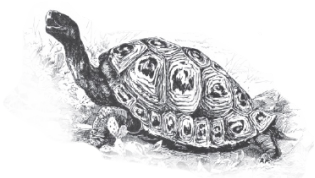
It appears that Wedgwood pottery was once all the rage. Wedgwood, sensing the great escalating demand for such things, built the first industrialized pottery manufacturing plants. As the insatiable appetite of the new upwardly mobile populace sought even more of Wedgwood's pottery, Wedgwood began to experience the challenges of meeting increasing demand and business expansion, such as liquidity problems, quality control, and insufficient capital resources (*id*. at 137).

In response to the mounting business crisis, Wedgwood applied double-entry accounting in an exhaustive assessment of profits and profitability. He learned that the company's pricing was arbitrary, its deployment of capital reactionary, its production runs too short, and its costs expenditures on raw materials, labor, and other production costs "unexpectedly large." During his exhaustive assessment, Wedgwood discovered the difference between fixed costs and variable costs and immediately understood the distinction between the two for his business. Fixed costs are costs that do not change in total as a result of a change in the cost driver (over a specific relevant time period). Variable costs are costs that do change in total due to changes in the cost driver. Thus, as a cost driver measure increases, total variable costs increase. Wedgwood also gained keen insight into the relationship between fixed and variable costs. He learned through double-entry bookkeeping that variable costs on a per unit basis remain constant, that is, the variable costs for a piece of pottery remained the same for that type of pottery. He also learned that fixed costs on a per unit basis did not remain the same; such costs actually went down so that the firm could experience greater and greater profits. Wedgwood, through the lens of double-entry bookkeeping, had discovered the profitability of mass production (*id*. at 138).

Gleeson-White depicts the Wedgwood experience as one of the first recorded instances of the use of cost accounting. "Wedgwood's examination of his costs was a response to the problems raised by the new industrial business conditions created by the factory system and is an early example of the way in which the industrial revolution transformed double-entry bookkeeping" (*id*. at 138-139).

Wedgwood, through the use of cost accounting in his pottery manufacturing business, amassed a great fortune. What could have been a financial disaster, the failure to understand the nature, characteristics, and behavior of costs, was averted by the use of double-entry bookkeeping and the discipline and knowledge it brought to the otherwise mundane but important keeping of accounts.

But what Josiah Wedgwood did with that fortune may have provided the world with a profound and unprecedented way of looking at itself. You see, Wedgwood had several grandchildren, one of whom he doted on, named Charlie. Charlie did not seem to quite fit the industrialist mold. But his patient and loving grandfather did not care, seeing the adventurer and intellect in Charlie. Using his great fortune, generated from a thorough understanding of cost accounting and the importance of a profits and profitability analysis performed on a regular basis, Wedgwood funded his grandson Charles Darwin's voyage of adventure on the *Beagle*. The rest, as the ancients say, is history



EVENT

SEPTEMBER 9, 2014
9TH ANNUAL NYIC/ABI GOLF AND TENNIS OUTING
MAPLEWOOD, NJ

OCTOBER 14, 2014
3RD ANNUAL FUTURE LEADERS AWARDS
ARNO RISTORANTE, NYC

OCTOBER 21, 2014
NYIC/IFA NORTHEAST JOINT LUNCHEON PROGRAM
ARNO RISTORANTE, NYC

OCTOBER 23, 2014
"PRE-VIEWS" FROM THE BENCH -- DINNER
WASHINGTON, D.C.

NOVEMBER 13, 2014
WOMEN'S DIVISION LUNCHEON PROGRAM
UNION LEAGUE CLUB, NYC

NOVEMBER 18, 2014
NYIC/TMA NY 12TH ANNUAL HOLIDAY COCKTAIL RECEPTION
BRYANT PARK GRILL, NYC

DECEMBER 10, 2014
NYIC HOLIDAY LUNCHEON PARTY
ARNO RISTORANTE, NYC

JANUARY 29, 2015
ANNUAL NYIC/AIRA JOINT EVENT
ARNO RISTORANTE, NYC

FEBRUARY 18, 2015
NYIC FUTURE LEADERS & ACG NY EMERGING PROFESSIONALS
UNION LEAGUE CLUB, NYC

FEBRUARY 26, 2015
8TH ANNUAL WOMEN IN ACHIEVEMENT AWARDS
UNION LEAGUE CLUB, NYC

MARCH 10, 2015
8TH ANNUAL NYIC/IFA NORTHEAST FACTORING PROGRAM
ARNO RISTORANTE, NYC

MARCH/APRIL 2015
8TH ANNUAL EDUCATION & NETWORKING CONFERENCE
VILLANOVA, PA

MAY 7TH -8TH, 2015
9TH ANNUAL CREDIT & BANKRUPTCY SYMPOSIUM
MOHEGAN SUN CASINO, CT

JUNE 2, 2015
96TH ANNUAL AWARDS BANQUET
NEW YORK HILTON, NYC

JULY 28, 2015
ANNUAL FUTURE LEADERS' ROOFTOP NETWORKING RECEPTION
TOP OF THE STRAND, NYC

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IRS RULING EXPLAINS CRIMINAL RESTITUTION PROCEDURES

In the case of some delinquent taxpayers, the Internal Revenue Service seeks criminal prosecutions and in many of those cases, the court issues an order requiring restitution to the federal government for the amount of delinquent taxes, interest and penalties. IRS recently issued a Memorandum (SBSE-05-0114-0005) on Procedures for Processing Bankruptcy Cases With Restitution Assessments dated January 22, 2014. Although the entire ruling is long and detailed, it does contain very helpful examples illustrating some of the procedures.

Background

Following the conviction of a defendant for a criminal tax violation or tax-related offense, the court may order the defendant to pay restitution called a Judgment and Commitment (J&C) Order. In 2010, Congress amended IRC §6201 to provide that the IRS shall assess and collect tax-related restitution in the same manner as if such amount were tax. This change in section 6201 applies to restitution in all J&C Orders entered after August 16, 2010. Restitution assessments can be made against individuals and businesses:

Example 1

Taxpayer A was convicted of criminal failure to collect or pay over tax under IRC §7202, and was ordered to pay restitution in the amount of $30,000. This amount was calculated based on the tax loss to the government resulting from the taxpayer's failure to pay employment taxes in the amount of $10,000 for each of the last three quarters of 2007. The assessment will be made against Taxpayer A, under his social security number, even though the assessment relates to the liability of a business. Restitution-based assessments will be a mirror assessment of (although not necessarily identical to) the tax liability assessed pursuant to a civil exam, creating two separate assessments. Although the restitution-based assessment and civil tax liability assessment are distinct, the IRS generally may not collect both in full for the same period because it would be impermissible double collection. In these cases, any payments made to satisfy the restitution-based assessment must also be applied by the Service to satisfy the civil tax liability for the same tax periods.

Example 2

Taxpayer B is an officer of a Corporation B and was convicted under IRC §7202 of criminal failure to collect or pay over corporate income tax for 2007 and ordered to pay restitution. The restitution was calculated based on the tax loss resulting from the taxpayer's failure to collect, account for, and pay over Corporation B's 2007 income tax. In addition to this restitution order that covers corporate income tax liabilities, Taxpayer B is also personally liable for the same tax period (2007) for nonpayment of his personal income tax liability. In this situation, collection of both assessments in full is permissible; the Service will be separately collecting the Taxpayer B's restitution-based assessment as well as the assessment of his personal income tax liability for the same year without cross referencing the two accounts.

When the Taxpayer Files a Bankruptcy Petition

When a taxpayer against whom a restitution assessment has been made has filed bankruptcy, the IRS Centralized Insolvency Operation (CIO) will be notified. Field Insolvency will work all cases with Criminal Restitution assessments. These cases will not be assigned to CIO.

Proofs of Claim

Example—The J&C Order directs the taxpayer to pay restitution for income tax the taxpayer evaded for the tax year 2005. The amount of restitution is assessed on September 12, 2011. On September 12, 2012, the taxpayer files a Chapter 13 bankruptcy case. The restitution assessment is not classified as priority, as the return was due more than three years prior to the filing of the bankruptcy petition, and the restitution assessment was more than 240 days prior to the bankruptcy petition. Because the restitution assessment does not fall within any of the reasons for classifying it as priority, a general unsecured on the proof of claim will be filed for the amount of the restitution assessment and the related interest. [In appropriate circumstances the claim can be a priority claim or a secured general claim].

The ruling goes on to cover many other situations including provisions for payment under a bankruptcy plan, when dischargeable and what happens when the debtor fails to make payments according to the plan.

IRS AUDITORS NOT TO CHALLENGE QUALIFYING MILESTONE PAYMENTS

In a recent Internal Revenue Service directive, field auditors were instructed by IRS executives not to challenge milestone payments which meet the definitions listed below. This is a clarification of previous IRS guidance in Revenue Procedure 2011-29 which created a "safe harbor" election to deduct 70% of milestone payments made in connection with certain business acquisitions. The remaining 30% must be capitalized. (IRS Directive LB&I-04-0114-001)

Scope

The Directive applies only to investment banker fees incurred by either an acquiring corporation or a target corporation. This Directive applies only for the amounts deducted on original timely filed returns, and not for amended return claims, whether formal or informal.

Qualifying Payments

A. The term "covered transaction" is a transaction described in §1.263(a)-5(e)(3) of the Income Tax Regulations:

   (i) a taxable acquisition by the taxpayer of assets constituting a trade or business;

(ii) a taxable acquisition of an ownership interest in a business entity if immediately after the acquisition, acquirer and the target are related within the meaning of I.R.C. §267(b) for corporations or §707(b) for partnerships; or

(iii) a nontaxable corporate reorganization described in §368(a)(1)(A), (B), (C), or a type D spin off

B. The term "milestone" means an event, including the passage of time, occurring in the course of a covered transaction (whether the transaction is ultimately completed or not).

C. The term "milestone payment" means a non-refundable amount that is contingent on the achievement of a milestone.

D. The term "eligible milestone payment" means a milestone payment paid for investment banking services that is creditable against a success-based fee.

COURTS UPHOLD FANNIE MAE AND FREDDIE MAC EXEMPTIONS FROM STATE TRANSFER TAXES

The Fourth Circuit recently upheld two Federal District Court decisions that the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac") are exempt from the payment of state and local taxes imposed on the *transfer* of real property in Maryland and South Carolina. Fannie Mae and Freddie Mac claimed exemption from state transfer taxes under 12 U.S.C. §§1723a(c)(2) and 1452(e), respectively. Counties in Maryland and South Carolina had argued that those exemptions do not, as a matter of statutory interpretation, apply to state and local taxes relating to real property, including transfer taxes, and (2) that, in any event, exempting Fannie Mae and Freddie Mac from state and local transfer taxes for real property would be unconstitutional as an infringement on the States' taxing power. The district courts in Maryland and South Carolina rejected the Counties' arguments, concluding that the general tax exemptions applicable to Fannie Mae and Freddie Mac, while not applicable to real property taxes, did cover real property *transfer* taxes, thus making a distinction between property taxes and transfer taxes. The courts also concluded that Congress, in providing the tax exemptions to Fannie Mae and Freddie Mac, acted within its Commerce Clause power. (*Montgomery Cnty. v. Fed. Nat'l Mortg. Ass'n*, 4th Cir., No. 13-01691, 1/27/14).

COURT MAKES IRS PAY TAX REFUND TWICE

In the case of Zahid and Shahida Naeem, the trustee in bankruptcy prepared and filed amended federal and state tax returns for the debtors' prepetition tax years in which he carried back net operating losses. The amendments resulted in federal tax refunds of $31,770. The Internal Revenue Service accepted the amended returns and issued a refund check. Unfortunately, the IRS improperly mailed the refund checks to the debtors, not the trustee. The trustee sought to recover the refunds from the debtors, but Ms. Naeem had cashed the refund checks and spent the money. The trustee then filed an adversary proceeding against the IRS and successfully obtained an order requiring the IRS to turn over the tax refunds to him. The IRS did not appeal the judgment. It complied with the turnover order and paid the trustee the tax refund of $31,770. It then filed a proof of claim for the $31,770 it had mis-delivered to Ms. Naeem, asserting a priority tax claim for it under §507(a)(8). The trustee objected. (*In re Zahid Naeem and Shahida Mughal Naeem, Debtors. Kevin R. McCarthy, Trustee, Objector v. Internal Revenue Service, Creditor.* U.S. Bankruptcy Court, E.D. Virginia, Alexandria Div.; 09-20542, January 24, 2014.)

Positions of the Parties

The IRS argued that the refund it paid to Ms. Naeem was an erroneous refund. Under Bankruptcy Code Section §507(c) "a claim of a governmental unit arising from an erroneous refund … has the same priority as a claim for the tax to which such refund or credit is due." Because it was a post-petition erroneous refund arising from tax periods within three years prior to the filing of the petition, its claim is entitled to priority. In this case, the IRS claim is the highest priority claim. In short, except for administrative expenses, the IRS would get its erroneous refund back from the trustee as a distribution from the estate. B.C. §§502(i) and 507(a)(8).

The trustee counters that sending a properly issued refund check to the wrong address is not an erroneous refund. He distinguishes between whether the refund should have been sent at all and where the refund should have been sent. He argues that only a refund that should have never been issued in the first place is an erroneous refund under B.C. §507(c). Here, the IRS sent a properly issued refund check to the wrong address. The trustee argues that it would be unfair for the unsecured creditors to bear the burden of the IRS's mistake and the debtor's wrongful conduct.

Decision

Following previous precedents the court ruled "In this case, no tax is owed by anyone. All taxes have been paid in full. The IRS sent the tax refund to the wrong address and the debtor cashed the check and spent the money. The remedy is to recover the money from the debtor who was unjustly enriched by it." The IRS proof of claim against the bankruptcy estate was disallowed.

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