AIRA | Association of Insolvency & Restructuring Advisors

Journal

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Economic Outlook

The Times Have Changed

By Patrick J. O'Keefe

WHAT'S INSIDE

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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

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Bederson LLP

I hope the first quarter of 2015 has been a prosperous one for AIRA members! I would like to share with you some big changes at AIRA. First up, welcome to **AIRA's Puerto Rico Chapter**, our first chapter, which will include the 48 current AIRA members (among them 13 CIRAs and 7 more awaiting experience requirements) and others as they sign up. The AIRA Board voted at its January meeting to update the by-laws to incorporate the chapter structure. Thanks to board member **José M. Monge Robertín, CIRA** (Monge Robertín & Asociados, Inc.) for leading this effort. See p. 5 of this issue for more details.

Second, the Board has significantly revitalized its committees. Every board member has committed to pursuing various aspects of the necessary behind-the-scenes tasks required to ensure the smooth operation of the organization. In addition, we are looking for members that are interested in participating on a committee – please feel free to contact Grant, any of the board members or me and we will help find something that fits your interest. This is another way AIRA provides value to its members.

Third, be on the lookout for AIRA's new website, coming soon. With more functionality and members-only benefits, we are seeking to realize more ways to serve members and support and enhance programs and events. A preview of the new look and interactive capabilities of the website can be seen as soon as you land on the home page for AC2015 – thanks to Mike Stull, AIRA's Director of Information Technologies.

Several events in January and February helped set the pace for a great year in 2015. Joining forces with the **New York Institute of Credit**, AIRA co-sponsored the 10th Annual Joint Bankruptcy and Restructuring Luncheon and Networking Event on January 29th. The following week, **NYIC, TMA New Jersey** and other organizations including **AIRA** hosted the second annual **Super Networking Party**, which was delayed until the week after Super Bowl due to a massive winter storm – everyone in attendance was thawed out by food, drink, fun and contests. In February, for the first time AIRA participated in **TMA's Distressed Investing Conference** in Las Vegas, followed days later by **VALCON15** on February 25–27, also in Vegas and jointly sponsored by **AIRA**, **ABI** and the **University of Texas**.

On Tuesday June 2, I am looking forward to attending the **New York Institute of Credit's 96th Annual Banquet**, June 2, 2015, 5:00-8:00 pm at the New York Hilton and Towers. The crowd is always huge but there's always room for more, and we have the pleasure of recognizing Hon. Rosemary Gambardella with the 10th Annual Conrad B. Duberstein Memorial Award.

The latter event concludes in plenty of time to allow participants to arrive in Philadelphia for **AIRA's 31st Annual Bankruptcy and Restructuring Conference, June 3-6 at The Ritz-Carlton Philadelphia**. The complete conference schedule with program details and registration are up and running at www.aira.org. Along with outstanding speakers from New York, New Jersey, Pennsylvania, Maryland, Virginia and others including a record number of judges, we have an outstanding assortment of networking events and excursions: golf at Woodcrest Country Club, our traditional MLB outing (Phillies vs. the defending World Series Champion SF Giants), and Barnes Museum, Segway and Philly Food Tours (that's three separate tours, not 3-in-1!). We owe many thanks to all of our committee members and especially our co-chairs – **Charles Persing, Angela Shortall and Joel Waite** – and Judicial Co-chairs – **Hon. Rosemary Gambardella** and **Hon. Kevin Carey**. For details on all of these events and others, keep an eye on www.aira.org and watch for emails and social updates.

As the first half of 2015 flies by at light speed, take a minute now to remember the pressure you were under to submit your last-minute CPE credits at the end of last year. Why go through that again? Take advantage of **AIRA's webinar series** in the coming months. These 1 hour courses are inexpensive, informative and convenient – you don't even have to leave your desk! Watch for your weekly **AIRA Advisor** for upcoming sessions including one on April 22 "Challenges for Mid–Tier Government Contractors" see www.aira.org for more information and registration.

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NEW YORK INSTITUTE OF CREDIT
FOUNDED IN 1918

JUNE 2, 2015

NYIC's 96th Annual Banquet

New York Hilton & Towers, 1335 Avenue of the Americas

THE NEW YORK INSTITUTE OF CREDIT IS PLEASED TO ANNOUNCE THE PRESENTATION OF THE:

10th Annual Conrad B. Duberstein Memorial Award
For Excellence and Compassion in the Bankruptcy Judiciary

Honorable Rosemary Gambardella
United States Bankruptcy Judge, ***District of New Jersey***
Presenter: Honorable Gloria Burns, Chief Judge, U.S. Bankruptcy Court, District of New Jersey

42nd Leadership in Credit Education Awards
This prestigious honor is bestowed upon two individuals who have demonstrated dedication and commitment to the New York Institute of Credit and the Credit Industry

Jay Goffman, *Global Head of Corporate Restructuring,*
Skadden, Arps, Slate, Meagher & Flom LLP and Affiliates
Presenter: Albert Togut, Partner, Togut, Segal & Segal LLP

Jonathan Lucas, *President,* ***CIT Commercial Services***
Presenter: Marc Heller, EVP/Northeast Regional Manager, CIT

AGENDA:
5:00PM – Registration, Cocktails & Networking
6:00PM – Guests will be seated
6:15PM – Opening Remarks, Presentation of the 42nd Leadership in Credit Education Awards and the 10th Annual Conrad B. Duberstein Memorial Award, followed by Dinner
7:45PM – Dessert & Coffee

FOR INFORMATION AND REGISTRATION VISIT
WWW.INSTITUTEOFCREDIT.ORG

President's Letter, Cont.

And if you like the webinars, contact board members **Ed Ordway** (chair of the committee) or **Larry Ahern** to thank them for their efforts, suggest topics or help with future programs.

I never get tired of chatting about the **AIRA-Grant Newton Educational Endowment Fund**. Thanks to generous contributions from the Board and members, we have raised over $70,000. There are now spaces on the membership renewal and AC 2015 registration forms where you can make a voluntary contribution. Please consider a gift as you renew your membership or register for the conference; there is no minimum and all contributions are gratefully received. You can also go to www.aira.org, click on the link in the Endowment Fund box for more information and make a donation online.

And finally, a shout-out to board member **Andrew Silfen**, recently named Managing Partner of Arent Fox's New York office. Congratulations, Andrew! (see Members in the News on p. 25)

In closing, I wish everyone the best in 2015 – I hope to see you in Philadelphia, New York or elsewhere – or just call to chat!

DIRECTOR'S COLUMN

AIRA Establishes Chapter in Puerto Rico

In January at its meeting held at El Conquistador Hotel in Fajardo, P.R., AIRA's Board modified Article IV of its bylaws to include Section 14 providing for the establishment of chapters. The Directors went on to approve chapter bylaws for the new Puerto Rico Chapter including a provision that AIRA's Vice President for Puerto Rico – an office currently held by José M. Monge Robertín, CIRA – shall serve as chapter director.

The Commonwealth of Puerto Rico is subject to the US Bankruptcy Code, except for Chapter 9, and the United States Bankruptcy Court District of Puerto Rico has four judges, with courthouses in Old San Juan (North) and Ponce (South). The judges are: Chief Judge Enrique S. Lamoutte, Judge Brian K. Tester, Judge Mildred Cabán, and Judge Edward A. Godoy.

The mission of the Puerto Rico Chapter includes:

- supporting development of the insolvency advisory profession in Puerto Rico
- establishing relationships with the Office of the US Trustee, PRBB, the Bar Association, Colleges and Universities and other government agencies
- presenting seminars in the Island in conjunction with the CPA Society, PR Bankruptcy Bar, US Trustee's Office, municipalities and other organizations
- developing practice guidelines to facilitate reorganizations in Puerto Rico

The chapter organizing committee consisted of José M. Monge Robertín, CIRA; José J. Negrón, CIRA; José Mendoza, CIRA; Maria Peña, CIRA; Miguel Moreda, CIRA, and Ana Morales, CIRA. In Puerto Rico there are at present 48 active AIRA members, thirteen CIRAs and seven CIRA candidates pending fulfillment of experience requirements. The Chapter has elected its first local Board of Directors which include the members of the Organizing Committee and Albert Tamárez, CIRA. Working jointly with the Puerto Rico Society of CPAs, AIRA has conducted six CIRA courses, plans to schedule three more CIRA courses in 2015, and is working to offer the CDBV program and an Insolvency and Restructuring Forum in 2015.

Forrest Lewis Concludes Nine-Year Stint as Tax Section Editor

This issue of AIRA Journal includes the final Bankruptcy Taxes section by Forrest Lewis, CPA, a retired Partner with Plante Moran. Forrest has served in this role since 2006 when he offered to write a regular section on taxes. The Bankruptcy Taxation section first appeared in the February/March 2006 edition and thanks to Forrest's dedication, it has consistently provided readers with incisive articles, updates and case summaries for nine years. At its 28th Annual Conference in San Francisco, AIRA presented an award to Forrest recognizing his contribution to AIRA Journal.

Forrest worked with Plante Moran since 1974 when he joined the tax department of a predecessor of Plante Moran CPAs. He served a variety of corporate and partnership clients and his bankruptcy assignments included Enron and General Motors. After retiring in 2005 he continued to work part time until his retirement this year.

On behalf of AIRA's Board and its members, I thank Forrest for his support of AIRA and AIRA Journal, and for his commitment to the profession, wishing him all the best in his new adventures!

GRANT NEWTON, CIRA
AIRA Executive Director

FEATURE ARTICLE

Economic Outlook: The Times Have Changed

PATRICK J. O'KEEFE
CohnReznick

The U.S. economy entered 2015 on a relatively solid footing and is expected to maintain its recent pace of growth despite the Federal Reserve's shift toward a less stimulative posture and decelerating growth abroad.

The consensus forecast is for inflation-adjusted gross domestic product ("real GDP") to grow about 3.2% in 2015. If so, that will be the strongest performance since before the 2008-2009 recession.

Since the recession ended in mid-2009, most headline measures (e.g., real GDP, employment, inflation-adjusted incomes and spending), indicate that the economy has recovered. Yet surveys of businesses and household sentiment suggest that while the private sector's outlook has improved, its confidence is circumscribed.

To some extent this is because the recovery was extraordinarily slow. It took two years for real GDP to regain its pre-recession peak (triple the post-war average). The jobs recovery required more than four years (post-war average: 11 months).

Compounding that sluggish pace, the recovery remains incomplete in important ways, for example:

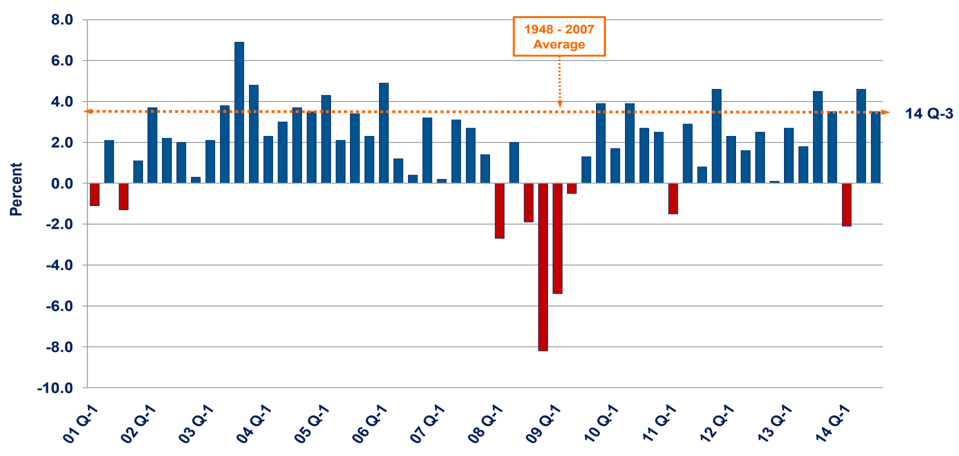
- Business investment (inflation-adjusted) is at mid-2006 levels;
- Labor force participation and employment rates (i.e., job-holders as a share of the work-age population) are near re-cessionary lows;
- Paychecks are contributing a smaller share of after-tax in-comes than at any time prior to the recession.

As noted in Exhibit 1 below, the forecast is that 2015's growth will be the strongest since 2005. But it will also be the 13th year (of the 14 since 2000) in which real GDP's gain was below the 60-year pre-recession average.

That sustained sub-par performance suggests that the economy's trend rate of growth (TRG) has shifted downward. Although there is insufficient data to estimate the degree of deceleration, there is no doubt that it will have significant implications — including for those who advise on the integration of existing enterprises or restructuring/resolution of distressed entities.

As discussed below, the TRG's deceleration reflects several long-term constraints, including the impacts of: persistent fiscal imbalances, financial re-regulation and cumulative debt burdens.

EXHIBIT 1: U.S. GROSS DOMESTIC PRODUCT
REAL PERCENTAGE CHANGE - QUARTER-ON-QUARTER 2001-2014



Seasonally adjusted annual rate: 2014 Q-3 advance estimate

Source: Bureau of Economic Analysis

Prospectively, the "normalization" of monetary policy will, *cet par.*, impinge on the rate of expansion, but the Federal Reserve will seek to minimize that drag via the timing and pace of its interest rate and balance sheet adjustments.

Fiscal Imbalances

The Federal government recorded a fiscal surplus in 12 of the 61 years between World War II demobilization and the recession's start. Over that span, including the surplus years, the Federal deficit averaged 1.6% of nominal GDP.

With the onset of the contraction, the deficit soared, reaching 9.8% of GDP in fiscal 2009, and then declined gradually to 2.8% of GDP in the fiscal year that ended on September 30.

In dollars: fiscal 2009's deficit was $1.4 trillion; 2014's was $483 billion. Despite that significant progress, in 2014 the Federal government borrowed almost one of every seven dollars it spent which, relative to GDP, exceeds the post-war average.

Ironically, the decline in the deficit came at the expense of economic growth as the stimulus provided by Uncle Sam's borrowing/spending began to dwindle in 2013, before private spending and investment had accumulated sufficient momentum to boost the recovery's pace. (See Exhibit 2 below).

Prospectively, the Federal deficit is poised to grow (even with an expanding economy) from 2017 forward. Over time, the expanded borrowing — which under current law is driven largely by demographic trends — will pressure interest rates and increasingly impinge on private investment, to the detriment of the economy's growth potential.

Financial Re-Regulation

In the aftermath of the meltdown of financial markets globally, the governments of the advanced economies enacted "never-again" legislation. In the U.S., this took the form of the *Dodd-Frank Wall Street Reform and Consumer Protection Act,* which was enacted in July 2010.

The law is comprehensive and, therefore, complicated. Its table of contents alone runs 11 pages. (At adoption, the *entire* text of the U.S. Constitution ran 5 pages).

To assure that its reforms would be expeditiously implemented, Congress established a detailed regulatory framework. It mandated 398 separate rulemakings, with precise adoption dates for 280.

The Act's precision and urgency reflected two Congressional priorities: first, the need to avoid another financial maelstrom; second, to make "the rules of the game" clear (and thereby reduce uncertainty) for citizens, financial institutions, and regulators.

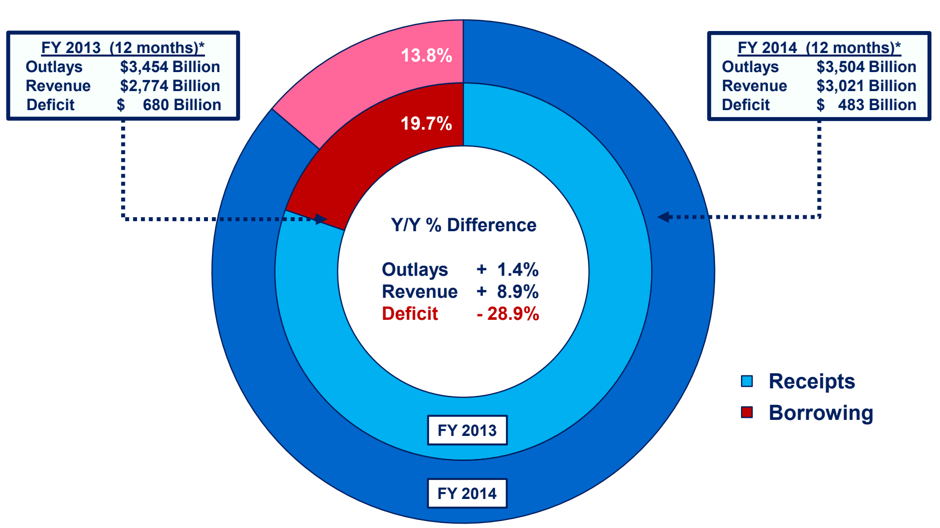
But reality has not conformed to Congressional intent. According to *Davis Polk's* regulatory tracker, by this October (more than four years after enactment): 55% of the Act's required rules had been adopted; two-fifths of its deadlines had been missed; and for one-quarter of the required regulations, no formal rulemaking had been proposed. Dodd-Frank, like most enactments, offers both potential benefits and costs. At this juncture, we lack the basis to assess whether its benefits will outweigh its costs.

Financial Re-Regulation (Dodd/Frank) Implications for Nonfinancial Sectors

- Reduction in systemic risk.
- Financial services more expensive.
- Indeterminate period of heightened uncertainty.
- *Less* credit for fewer borrowers on more restrictive terms and at higher costs.

We do know two things, however: First, the U.S., like all advanced economies, is credit dependent. Second, the long-term impact of a fully implemented Dodd-Frank will be that fewer potential borrowers will be eligible for a diminished supply of credit extended under more restrictive terms and at higher costs (fees and rates). As a consequence, the economy's growth potential will be constrained.

EXHIBIT 2: U.S. FEDERAL GOVERNMENT OUTLAYS BY FUNDING SOURCE FISCAL YEARS 2013 AND 2014



*Federal fiscal year is October through September; data through September 2014

Source: U.S. Treasury

Debt Burdens

From the start of the Millennium through 2009, nominal GDP and outstanding nonfinancial debt (i.e., debt owed by the businesses, households and governments) both increased, by 47% and 100% respectively. In other words: due to GDP's recessionary contraction and a decade's cumulative borrowing, total debt accumulated twice as fast as the economy grew (See Exhibit 3 below).

Since then, the nation's debt-to-GDP ratio has tightened, albeit marginally, on the combination of an expanding economy, declining household indebtedness (viz., mortgage balances) and dwindling Federal deficits.

Business sector debt neither declined nor decelerated, however. Between the end of 2009 and mid-2014, it increased $1.3 trillion as firms responded to gradually rising demand and historically low interest rates. Calendar year 2013 saw nominal business debt increase to a record level. In the first half of 2014, it rose another 6%.

And while Federal deficits have dwindled since 2009, Uncle Sam still borrowed almost $500 billion in the fiscal year that ended on September 30. The nonpartisan Congressional Budget Office (CBO) forecasts another decline this year, but expects Federal borrowing to trend upward thereafter.

At its current size relative to the total economy, the Federal deficit is benign. However, CBO forecasts that both annual deficits and cumulative Federal debt – either in absolute amounts or as percentages of GDP, and all adjusted for inflation – are poised to rise after 2017. And the rate of increase is projected to accelerate gradually over the next decade. Barring changes in the current policy mix, this implies rising interest rates (in addition to the increases inherent in the Federal Reserve's policy "normalization") and declining investment. This scenario is not inevitable, but neither is it improbable.

In Sum

The near-term outlook for the U.S. economy is favorable. Output and employment should continue to expand through 2015 and the rate at which real incomes rise should accelerate.

Longer-term, the U.S. economy should continue to grow but at a considerably slower pace than the 3.5% annual average experienced in the 60 years prior to the recession.

ABOUT THE AUTHOR

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Patrick J. O'Keefe is Director of Economic Research for CohnReznick, one of the top accounting, tax, and advisory firms in the U.S. He is a regular contributor to financial news outlets such as The Wall Street Journal, CNBC, The New York Times, Fox Business News, Financial Times, Los Angeles Times, TheStreet.com and Bloomberg Radio. His topics of discussion typically include: gross domestic product, employment and incomes, financial conditions, and fiscal outlook. . For a full-length bio, see http://www.cohnreznick.com/patrick-j-o'keefe

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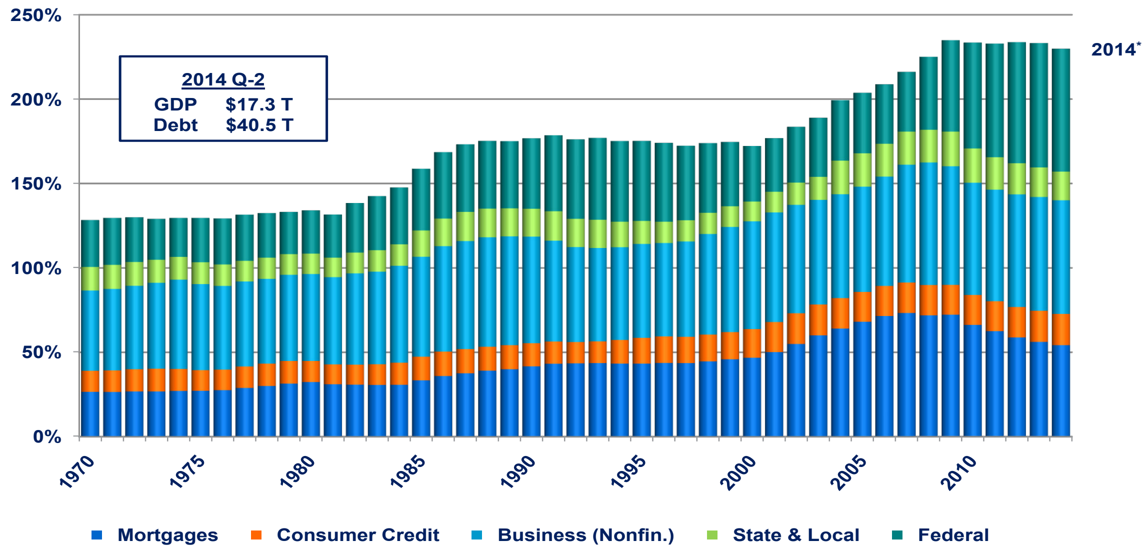
EXHIBIT 3: U.S. NONFINANCIAL DEBT SECTORS AS PERCENT OF GDP 1970-2014*



*Through end of most recent quarter

Sources: Federal Reserve & Bureau of Economic Analysis

Treatment of Make Whole Provisions in Chapter 11 Cases

MICHAEL R. LASTOWSKI
Duane Morris LLP

Recent chapter 11 cases have spawned several disputes over the allowance of claims arising from make-whole provisions in credit agreements. In some instances, the stakes have been high. Enforceability of these provisions results in enhanced recoveries for noteholders and lenders at the expense of other creditors. While recent opinions teach us that the specific language of the underlying agreements determines the outcome of these disputes, the opinions also provide a helpful outline of issues that will determine enforceability.

Make Whole Provisions

Unless the loan documents provide otherwise, in many jurisdictions a commercial lender has the right to refuse a borrower's early repayment of its loan. *See, e.g., Arthur v. Burkich*, 520 N.Y.S. 2d 638 (N.Y. App. Div. 1987) (applying the so-called "perfect tender in time" rule). In the loan documents, a lender may waive this right, so long as the borrower's repayment includes a make whole premium. The make whole premium, a form of prepayment penalty, is designed to compensate the lender for the lost opportunity to earn the interest that would have accrued during the full term of the loan. During a period of low interest rates, make whole premiums are important to lenders who might otherwise suffer damages representing the difference between interest payments under the loan documents and the lower market rate of interest at the time of the prepayment.

Enforceability Under State Law

The determination of the allowance of a claim for a make whole premium first requires an inquiry into whether the make whole provision may be enforced under state law. Courts have characterized make whole premiums as prepayment penalties and have looked to state law relating to the latter to identify the criteria to determine enforceability. *See In re School Specialty, Inc., et al.,* 2013 WL 1838513 (Bankr. D. Del. April 22, 2013)(*citing United Merchs. & Mfrs. v. Equitable Life Assurance Soc'y of the U.S. (In re United Merchs. & Mfrs.)*, 674 F.2d 134, 141 (2d Cir. 1982)(looking to New York law to determine whether a liquidated damages clause was unenforceable as a penalty)). In *School Specialty*, for example, the court applied the traditional criteria to determine enforceability under state law: (1) whether, at the time of the agreement, actual damages were difficult to determine; and (2) whether the amount of the make whole premium is "plainly disproportionate" to the lender's actual damages. *Id*. at *2 (citations omitted).

Enforceability Under the Bankruptcy Code

A review of state law does not end the inquiry. 11 U.S.C. § 502(b)(3) provides that a bankruptcy court shall not allow a claim for "unmatured interest" presents a potential hurdle to recovery. Further, while 11 U.S.C. § 506(b) provides that an oversecured creditor may have an allowed claim for "interest," that claim may include "fees, costs, or charges" only to the extent that they are "reasonable." *Id*.

The School Specialty Decision

In *School Specialty*, the court entered an interim debtor in possession financing order (the "Interim DIP Order") under which the debtors stipulated that they were indebted to their lender, Bayside Finance LLC ("Bayside") in the aggregate principal amount of $95,024,001.06. This principal amount included an "Early Payment Fee" (*i.e.*, a make whole premium) of about $24 million. An official committee of unsecured creditors filed a motion seeking disallowance of the make whole premium.

Bayside's loan had an initial maturity date of October 31, 2014 (the "Initial Maturity Date"). However, if the debtors were able to refinance certain debentures, the maturity date would be extended to December 31, 2015 (the "Conditional Maturity Date"). In January 2013, the debtors and Bayside entered into a forbearance agreement under which debtors acknowledged a covenant default, acceleration of the loan and liability for the make whole premium. The premium was calculated by discounting future interest payments through the Conditional maturity date and the date on which the loan balance was accelerated.

With regard to the state law analysis, the committee focused on the second prong under New York law (*i.e.*, whether the amount of the make whole premium was "plainly disproportionate"). The committee argued that, to the extent that the premium was calculated based upon the Conditional Maturity date, and not the initial maturity date, Bayside was receiving a "grossly disproportionate" premium based upon a calculation that ignored "market place" formulas.

The court rejected the committee's arguments. The court found that: (1) the premium was calculated to provide to Bayside its "bargained for yield"; and (2) the premium was the product of "arms-length negotiations between sophisticated parties." Under New York law, these findings led to the conclusion that the premium was not disproportionate. Notably, the court rejected the argument that the premium should be calculated based on the Initial Maturity Date rather than the Conditional Maturity Date, finding however unlikely a refinancing and an extension of the maturity date might be, at the time of the loan, Bayside was still obligated to keep funds available until the Conditional Maturity Date and was justified in using that date to calculate the premium.

Noting, but not deciding, the issue of whether Section 506(b)(6)'s reasonableness requirement applies to amounts calculated prepetition (*i.e.*, as in the context to the debtor's prepetition forbearance agreement with Bayside), the court determined that, in any event, the premium was not "plainly disproportionate" and was therefore reasonable.

Finally, the court determined whether Bayside's claim for the make whole premium should be disallowed under Section 502(b)(3) as a claim for unmatured interest. In *In re Trico Marine Servs., Inc.*, 450 B.R. 474 (Bankr. D. Del. 2011), Judge Shannon had adopted the majority view that that prepayment charges do not represent unmatured interest because they become fully mature, by contract, prior to the maturity date of the underlying loan. Judge Carey adopted this holding.

The Momentive Performance Materials Decision

In contrast to *School Specialty*, the parties in *In re MPM Silicones, LLC*, 2014 WL 4436335 (Bankr. S.D.N.Y. Sept. 9, 2014) ("Momentive"), disputed whether a make whole premium was due under the terms of the loan documents. The dispute arose in the context of plan confirmation. The indenture trustees for holders of approximately $1.1 billion in First Lien Notes and of $250 million in so-called 1.5 Lien Notes objected to the debtors' plan, which did not provide for payment of make whole premiums under the indentures. Payment of the premium would increase distributions to the noteholders in an amount exceeding $200 million.

Judge Drain noted the general application of the "perfect tender in time" rule under New York law and the exception to that rule where a lender agrees that a borrower may prepay a loan under certain conditions, including the condition that the borrower pay a make whole premium. Under New York law, however, a lender forfeits its rights to such a premium where the lender accelerates the payment of the debt, unless (1) the borrower purposefully defaults to trigger acceleration; or (2) the agreement expressly provides for payment of the premium upon the lender's acceleration. *Id*. at *13.

In *Momentive*, the agreements provided for acceleration upon the borrowers filing for bankruptcy. However, the agreements did not expressly provide for payment of a make whole premium in the event of such an acceleration. Although the noteholders had bargained for prepayment upon a bankruptcy filing, they had failed to obtain an obligation to include in the prepayment a make whole premium. *Id*. Stated differently, upon acceleration, the notes became fully mature. Prepayment can only occur prior to maturity and the loan documents did not provide otherwise.

Judge Gerber, in *In re Chemtura Corp.*, 439 B.R. 561 (Bankr. S.D.N.Y. 2010), had earlier reviewed the enforceabilty of a make whole premium in the context of approving a settlement embodied in a plan of reorganization pursuant to Fed. R. Bankr. P. 9019. The plan provided for payment to certain noteholders, which included a portion of a make whole premium. In *Chemtura*, the court noted that the documents provided for a make whole premium in the event that the debt was prepaid prior to the "maturity date." The maturity date was June 1, 2016. The language of the documents supported the noteholders, whom Judge Gerber characterized as having the better argument as to enforceability.

In *Momentive*, the noteholders urged Judge Drain to follow Judge Gerber. However, Judge Drain declined to do so, noting that the award of a make whole premium rises or falls on the language of the underlying agreements. "[U]nless the parties have *clearly and specifically* provided for payment of a make-whole . . . notwithstanding the acceleration or advancement of the original maturity of the notes, a make-whole will not be owed." *Id*. at *14, (*citing U.S. Bank National Association v. Southside House*, 2012 U.S. Dist. LEXIS 10824, at *2 (E.D.N.Y. January 30, 2012)) (emphasis added).

The noteholders identified other language in the indenture providing for "prepayment premiums" in the event of certain defaults. However, Judge Drain found that these references were vague and ambiguous and fell far short of the "clear and specific" standard set forth in the *Southside House* decision.

Finally, the noteholders argued that they were entitled to a claim for damages arising from the debtors' breach of the "perfect tender in time" rule. Judge Drain, however, characterized such damages as "unmatured interest" which are disallowed under 11 U.S.C. § 503(b)(2).

Conclusion

It would be superficial to conclude that the District of Delaware is friendly to make whole premiums while the Southern District of New York is hostile. As *School Specialty* and *Momentive* demonstrate, the enforceability of make whole provisions initially depends initially on the wording of the underlying agreements. In *School Specialty*, the parties did not dispute that the make whole provision had been triggered. The court, however, had to decide whether the provision was enforceable under state law and the bankruptcy code. In *Momentive*, by contrast, the agreements were not "clear and specific." Therefore, no make-whole obligation was triggered. The court only looked at the bankruptcy code in considering breach of contract as an alternate theory of recovery.

ABOUT THE AUTHOR

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Michael R. Lastowski is the managing partner of Duane Morris' Wilmington office. Mr. Lastowski practices in the areas of bankruptcy law and commercial litigation. Admitted to practice in Delaware, Pennsylvania and New York, Mr. Lastowski is a member of the Section of Litigation of the American Bar Association and is the former chair of the Bankruptcy Subcommittee of the Corporation, Banking and Business Law Section of the Pennsylvania Bar Association. He is also a member of the Unsecured Trade Creditor Subcommittee of the American Bankruptcy Institute. In 2014, he was appointed to the board of the Association of Insolvency & Restructuring Advisors (AIRA).Mr. Lastowski is a 1980 graduate of the University of Pennsylvania Law School and a graduate of Brown University.

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FEATURE ARTICLE

International Shipments: When "Received by the Debtor" Under Section 503(b)(9) of the Bankruptcy Code Might Not Mean Physical Possession

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AlixPartners, LLP

ROBERT F. POPPITI, JR.
Young Conaway Stargatt & Taylor, LLP

As restructuring professionals well know, with the passage of the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) in 2005, Congress passed sweeping changes to U.S. bankruptcy law. While the changes were mainly focused on individual consumer bankruptcy law, numerous changes have also had a significant impact on businesses seeking to reorganize under chapter 11. In particular, the addition of § 503(b)(9) of the Bankruptcy Code has been the topic of much discussion since its inception as a part of BAPCPA. This section of the Bankruptcy Code grants a creditor the right to seek an administrative expense claim for the "value of any goods received by the debtor within 20 days before the date of commencement of a case."

Among other things, § 503(b)(9) has been criticized as being too creditor-friendly, even to the point of some accusing it of being so hostile to debtors as to cripple many debtors' chances to successfully reorganize under chapter 11.[1] Nowhere has the impact of § 503(b)(9) been more evident than in the retail industry, where several high profile chapter 11 reorganizations have been unsuccessful and companies have been forced into liquidation at least in part due to the large cash demands under § 503(b)(9). For retail debtors whose cost of inventory typically makes up a substantial percentage of prepetition debt, conversion of what would have been (sans § 503(b)(9)) general unsecured trade credit into administrative expense claims can leave insufficient funds to successfully reorganize or prosecute a liquidating chapter 11 case, to the detriment of all estate creditors.

Prior to the implementation of BAPCPA, a creditor's best recourse for payment related to goods delivered just prior to a chapter 11 filing was under § 546(c), which provides for the preservation of state law reclamation rights. However, the process through which a vendor must assert reclamation rights can be rather complex. There must first be a state law remedy allowing for it, and then the vendor must meet a series of other tests. Creditors frequently struggle to meet these criteria because, among other reasons, the debtor is often the only one possessing some of the information critical to establishing a valid reclamation claim. Moreover, numerous bankruptcy courts have ruled, consistent with the provisions of the Bankruptcy Code, that reclamation claims are invalid where such claims are subject to the superior rights of a holder of a security interest in the reclaimed goods, namely a secured lender with a prior floating lien on the debtor's inventory.[2]

Arguably, the original intent of Congress when adopting § 503(b)(9) was to fix some of the common limitations and problems encountered by creditors asserting reclamation rights. Strengthening these creditors' rights would hopefully encourage suppliers to ship goods to customers even when rumors have circulated regarding the customers' financial viability and signs of an impending bankruptcy filing are evident. Disrupting the supply chain of an already struggling company, it was thought, would only further cripple the business and increase erosion of the value that was to be available for the benefit of all creditors. In adopting § 503(b)(9), Congress deviated from a fundamental principle of the Bankruptcy Code: that administrative expense claims should be carefully limited to postpetition transactions with the debtor that provide an actual and necessary benefit to the estate.

Section 503(b)(9) provides for the allowance of an administrative expense claim if the claimant establishes, among other things: (1) that it sold "goods" to the debtor; and (2) the goods were "received by the debtor" within twenty days before the petition date. In comparison with a claimant's efforts to establish a valid reclamation claim under § 546(c), a 503(b)(9) claimant now appears to have a much simpler task; however, the language of § 503(b)(9) leaves considerable ambiguity and uncertainty, as the key terms "goods" and "received by the debtor" are not defined in the Bankruptcy Code. Thus, bankruptcy courts are forced to turn to applicable non-bankruptcy law for guidance, often looking to the Uniform Commercial Code (UCC) and to case law on reclamation claims since § 546(c) also uses the terms "goods" and "received."

However, as discussed below, a recent ruling out of the United States Bankruptcy Court for the Eastern District of Pennsylvania adds further guidance to what constitutes a valid 503(b)(9) claim.[3] Before discussing this ruling, a brief background on the state of the law under § 503(b)(9) prior to this ruling is useful.

Relatively speaking, the definition of "goods" is more easily agreed upon. Typically, bankruptcy courts have turned to the UCC for its definition. The UCC defines goods as "all things (including specially manufactured goods) which are movable at the time

[1] Michael G. Wilson, Henry P. "Toby" Long III, "Section 503(b)(9)'s Impact: A Proposal to Make Chapter 11 Viable Again for Retail Debtors", ABI Journal, February 2011.

[2] *See, e.g., In re Dana Corp.*, 367 B.R. 409, 417-18 (Bankr. S.D.N.Y. 2007); *Simon & Schuster, Inc. v. Advanced Mktg. Servs. (In re Advanced Mktg. Servs.)*, 360 B.R. 421 (Bankr. D. Del. 2007).

[3] *In re World Imports, Ltd.*, 511 B.R. 738 (Bankr. E.D. Pa. 2014).

of identification to the contract for sale other than the money in which the price is to be paid . . . and things in action . . ."[4] Although it has been largely accepted that goods are tangible items that one can see and touch, the definition of goods is not without uncertainty. For example, some bankruptcy courts have found in favor of utility providers arguing that water, gas and electricity are goods for purposes of § 503(b)(9) (a consequence perhaps not contemplated by Congress), but even those courts have not always been in agreement on which of these utilities represent goods.[5] Furthermore, to the extent that they are goods, proving the value of utilities that were received by the debtors during the twenty-day window is both critical and often complicated.

While parties often (but not always) agree upon the definition of goods, the definition of "received" is a hotly contested matter. Again, the Bankruptcy Code does not define "received," so bankruptcy courts have regularly looked to the UCC for guidance. According to the UCC, "receipt" of goods is defined as "taking physical possession of them,"[6] and this definition has been adopted by the bankruptcy courts in *In re Wezbra Dairy, LLC*,[7] *In re Momenta, Inc.*,[8] and *In re Circuit City Stores*[9] as the appropriate meaning for "received." Although these bankruptcy courts have found that receipt means taking physical possession, there still remains a lack of nationwide consensus on this point, as an overwhelming majority of jurisdictions do not have the benefit of precedent from their bankruptcy courts (let alone their federal appellate courts), which leaves the door open for interested parties to adopt the definition most advantageous to them when reconciling and asserting such claims. Given the lack of case law in this area, presumably a large number of these disputes are settled without the need for potentially protracted and costly litigation that could outweigh the benefit to either side.

Moreover, a recent ruling from the United States Bankruptcy Court for the Eastern District of Pennsylvania has added further uncertainty to this arena, suggesting that in certain circumstances the UCC may not be the appropriate non-bankruptcy law to fill the definitional gaps left by the Bankruptcy Code. In *In re World Imports*, the bankruptcy court found that suppliers were not entitled to 503(b)(9) claims despite the fact that the debtor took physical possession of the goods sold within the twenty days prior to the petition date. The goods were shipped to the debtor FOB from Chinese ports, and were loaded onto vessels and shipped from China outside the twenty-day window. Not surprisingly, the suppliers argued that they were entitled to 503(b)(9) claims because the bankruptcy court, in defining "received" in § 503(b)(9), should adopt the UCC definition of receipt. The debtor and the creditors' committee, on the other hand, maintained that the receipt date is controlled by international law, and according to accepted terms of international trade, an FOB sale occurs in the country of origin, at which point the goods are transferred to the purchaser once loaded onto the vessel.

The premise of looking to state law when federal law is silent, as proposed by the claimants in *World Imports*, is, as noted above, well supported. That is, however, unless state law deviates from a federal interest. Specifically, Article VI of the U.S. Constitution (i.e., the Supremacy Clause) states that "This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme law of the land…"[10] Based on the Supremacy Clause, the debtor and the creditors' committee in *World Imports* argued, and the bankruptcy court agreed, that the Convention on Contracts for the International Sale of Goods (CISG)—a federal treaty—and not the UCC should fill the definitional gap for the term "received," because both the U.S. debtor and the Chinese supplier had ratified the CISG.[11]

Interestingly, however, the CISG, like the Bankruptcy Code, does not define "received." But, the CISG does state that where it does not explicitly provide guidance, the involved parties are assumed to have made applicable to their contract the use of commonly known and accepted rules governing international trade.[12] Therefore, the *World Imports* bankruptcy court looked to a set of commercial terms, known as Incoterms, established by the International Commerce Commission, used commonly in international trade and incorporated into the CISG. According to Incoterms, FOB stands for Free on Board, and under these shipping terms, the seller delivers the goods on board the shipping vessel at the named port of shipment. At this point, the risk of loss or damage to the goods passes to the buyer, and the buyer bears all costs going forward.

Based on this, the *World Imports* bankruptcy court went on to find that once the debtor assumed the risk for the goods at issue, the goods were constructively received by the debtor. In this case, possession occurred at the Chinese port outside of the twenty-day window. Therefore, the bankruptcy court denied the claimants' motions for allowance and payment of 503(b)(9) claims.

Although it is likely that the reach of the *World Imports* decision is limited to transactions between a debtor and a supplier from nations that have both signed the CISG, the decision nevertheless represents another important decision in the developing case law under § 503(b)(9). With the ever-evolving globalization of business, the number of disputes and complex issues in this area of law is likely to further develop in the coming years.

4 UCC § 2-105(1).

5 *See, e.g., In re NE OPCO, Inc.*, 501 B.R. 233, 259-60 (Bankr. D. Del. 2013) (electricity is not a good but gas is); *GFI Wisconsin, Inc. v. Reedsburg Util. Comm'n*, 440 B.R. 791, 802 (W.D. Wis. 2010) (electricity is a good); *In re Erving Indus., Inc.*, 432 B.R. 354, 370 (Bankr. D. Mass. 2010) (electricity is a good); *In re Pilgrim's Pride Corp.*, 421 B.R. 231, 240-43 (Bankr. N.D. Tex. 2009) (electricity is not a good but gas and water are).

6 UCC § 2-103(1)(c).

7 493 B.R. 768, 771 (Bankr. N.D. Ind. 2013) ("Thus, the key to determining when goods are received is possession – whether actual or constructive – not title.")

8 455 B.R. 353, 359 (Bankr. D. N.H. 2011) (holding that the term received in § 546(c) is the equivalent of receipt in the UCC and that the term received in § 503(b)(9) must be interpreted identically and could include constructive possession).

9 432 B.R. 225, 230 (E.D. Va. 2010) (holding that received under § 503(b)(9) means "having taken into physical possession").

10 U.S. Const. Art. VI cl. 2.

11 The CISG applies to "contracts of sale of goods between parties whose place of business are in different States...[w]hen the States are Contracting States," CISG Art. 1(1)(a), and is a self-executing treaty with the preemptive force of federal law. *In re World Imports*, 511 B.R. at 743-44. The CISG governs unless the parties have excluded its application. CISG Art. 6.

12 *Id*. at Art. 9(2).

From a practical perspective, with the benefit of the *World Imports* decision in hand, parties to an international business transaction should consider whether it is prudent to expressly provide in their contract or other agreement governing their business relationship that the CISG does not apply. For example, the parties might agree in writing that the CISG does not apply and that the UCC does. Of course, the best way for a supplier to protect itself is, and always will be, to place the purchaser on cash in advance to the extent possible in lieu of providing the financially troubled purchaser with payment terms.

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FEATURE ARTICLE

NOL Preservation for Bankrupt Corporations: Deciding Between §382 (l)(5) and (l)(6)

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When Congress enacted section 381 of the Internal Revenue Code (IRC)[1]—the provision governing the extent to which an acquiring company succeeds to the tax attributes of the target corporation following certain transactions—it sought to adopt tax attribute preservation rules enabling "the [acquirer] corporation to step into the 'tax shoes' of its predecessor corporation without necessarily conforming to artificial legal requirements which now exist under court made law."[2] Though section 381 provided a comprehensive statutory set of rules ensuring tax attribute preservation following certain transactions, its operation in isolation could potentially lead to the acquisition of corporations primarily because of their favorable attributes—the most valuable among them being the target's net operating loss carryforwards.[3] Not heedless of these potential abuses, Congress enacted additional IRC sections[4] that work in concert with already existing judicial doctrines[5] to deter acquisitions motivated primarily by tax avoidance. Of these tools at the IRS's disposal, the most effective are found in section 382.[6]

Section 382 limits the amount of otherwise available net operating loss carryforward following an ownership change involving a "loss corporation."[7] Given the tremendous value of net operating losses[8] (NOLs) to offset future income tax liability, acquirers naturally targeted corporations with high NOLs to offset their own future taxable income.[9] The congressional response, codified in §382, to this abuse was to limit NOL carryover when an ownership change occurs,[10] and completely eliminate NOL carryovers if a change in business takes place within two years following the change in ownership.[11] Section 382 and the regulations promulgated thereunder lay out in painstaking detail definitions for when an ownership change takes place and valuation procedures, including "anti-stuffing" rules,[12] and particular instructions for built-in gains and losses,[13] that work to limit NOL carryovers available to an acquirer.

While the various rules and limitations of §382 effectuate the congressional objective of curbing traffic in loss corporations,[14] a blanket application of §382's general pronouncements to all corporate acquisitions involving loss corporations would frustrate other objectives—specifically, objectives concerning corporate reorganizations in bankruptcy.[15] Most notably, corporations seeking reorganization via bankruptcy would quickly find themselves unmarketable and unable to obtain much needed equity

1 Under IRC §381(a), a corporation that acquires the assets of another corporation in a section 332 liquidation or in a reor-ganization qualifying under section 368(a)(1)(A), (C), (D), (F) or (G), succeeds to, and takes into account, as of the close of the date of distribution or transfer, certain items, including NOL carryovers, of the distributor or transferor corporation.

2 S. Rep. No. 1622, 83d Cong., 2d Sess. 52 (1954).

3 Infra note 8.

4 *E.g.*, IRC §269, which disallows any deduction, credit, or other allowance attempted to be secured through certain acquisitions of stock or property with the principal purpose of income tax avoidance

5 *E.g., The Libson Shops* doctrine, which may prohibit the carryover in a reorganization of losses against profits of a different business, *Libson Shops v. Koehler*, 353 U.S. 382 (1957); and Various other general principles related to sham transactions, tax avoidance, business purpose, form versus substance, clear reflection of income, step transactions, and assignment of income, and derived in large part from *Gregory v. Helvering*, 293 U.S. 465 (1935).

6 IRC §382.

7 "The term "loss corporation" means a corporation entitled to use a net operating loss carryover or having a net operating loss for the taxable year in which the ownership change occurs." IRC §382(k)(1).

8 IRC §172(c) defines "net operating loss" as "the excess of the deductions allowed by this chapter over the gross income," subject to specified modifications. An NOL, in turn, can give rise to a "net operating loss carryback" for two years prior to the year of the NOL, and a "net operating loss carryover" for twenty years after the year of the NOL. IRC §172(b)(1)(A).

9 In 1943, an advertisement appeared in the New York Times: "For Sale. Stock of corporation having 1943 tax loss deduction $120,000. Sole assets are $80,000 in cash and equivalent." Rudick, Acquisitions to Avoid Income or Excess Profits Tax: Section 129 of the Internal Revenue Code, 58 HARV. L. REV. 196 (1944). In February, 1960, the New York Times carried the following: "Tax Loss Corporation deals arranged." N.Y. Times, Feb. 7, 1960, § 3, p. 24, col. 1. "Loss Corporation for sale in retail discount or appliance field. Sacrifice." *Ibid.* "We want to merge with or acquire a profitable company with competent management—Our stock is listed on the American Stock Exchange. We have a sub stantial loss carry-forward but our operations are now decidedly profitable. We are prepared to buy for cash or stock or both." *Id.* § 3, p. 11, col. 7.

10 The legislative history of the IRC §382 explains in general terms why such a limitation is necessary: "[p]ermitting the carryover of all losses following an acquisitions, as is permitted under the 1954 Code if the loss business is continued following a purchase, provides an improper matching of income and loss . . . Furthermore, the ability to use acquired losses against such unrelated income creates a tax bias in favor of acquisitions." S. Rep. 99-313 at 231.The computation for the limitation is set out in IRC §382 (b)(post change yearly limitation equals value of old loss corporation multiplied by long term tax-exempt rate).

11 IRC §382 (c) (Except as provided in paragraph (2), if the new loss corporation does not continue the business enterprise of the old loss corporation at all times during the 2-year period beginning on the change date, the section 382 limitation for any post-change year shall be zero.)

12 IRC §382 (1)(1).

13 IRC §382(h)

14 A loss corporation is defined "as a corporation entitled to use a net operating loss carryover or having a net operating loss for the taxable year in which the ownership change occurs. Except to the extent provided in regulations, such term includes any corporation with a net unrealized built-in loss." IRC §382 (k)(1).

15 Including NOL carryforwards as property of a corporate debtor's estate is consistent with Congress' intention to "bring anything of value that the debtors have into the estate." H.R.Rep. No. 95–595, 95th Cong., 2d Sess. 176, reprinted in 1978 U.S.Code Cong. & Admin.News 5963, 6136.

as a result of the general limitations of §382—symptoms bankrupt companies are already all too familiar without §382's additional conditions.[16] In an effort to align both tax and bankruptcy objectives, Congress included NOL valuation rules for bankrupt companies in §382(l)(5) and (l)(6) that seek to take into account the exigencies particular to corporate bankruptcy.[17] This is not to say all NOL limitations have been lifted for acquisitions involving bankrupt companies; indeed, these rules have the potential of more severely reducing NOL carryforwards than §382's general pronouncements. Additionally, the sole similarity of (l)(5) and (l)(6) are there exclusive availability to bankrupt companies, thus failing to identify which provision maximizes NOL preservation can have drastic consequences. Accordingly, an understanding of the mechanics and consequences of both (l)(5) and (l)(6) is paramount for all parties involved in the acquisition of a bankrupt company. This paper seeks to provide a basic overview of the requirements and consequences for each paragraph with a following section identifying when one provision should be utilized over the other.

Section 382(l)(5)

Section 382(l)(5)(A) provides that the general NOL limitations rules contained in §382(a) shall not apply to any ownership change if the old loss corporation is (immediately before such ownership change) under the jurisdiction of the court in a Title 11 or similar case,[18] thus providing for a special bankruptcy exception to the general loss limitation rule under IRC §382(a).[19] The bankruptcy exception is in recognition of the fact that, by the time a corporation is in bankruptcy, it is often the corporation's creditors, and not its shareholders, who are effectively its economic owners and without the such exception, IRC §382's limitation equation[20] would result in minuscule NOL preservation for the post-change corporation.[21] But before switching the characterization of a creditor's investment from debt to equity for valuation purposes, certain adjustments must be made to reflect the true nature of their investment. The requirements, costs and consequences for a debtor corporation utilizing (l)(5) are the subject of the following section.

Under the Jurisdiction of the Court in Title 11 or Similar Case

The first and most obvious requirement for (l)(5)'s applicability mandates the old loss corporation be under "the jurisdiction of the court in title 11 or similar case."[22] The regulations supplement this condition by requiring the transaction be ordered by the court or pursuant to a plan approved by the court.[23] Though the provisions of (l)(5) most often applies to corporations under the jurisdiction of title 11, the "similar case" reference includes cases involving receiverships, foreclosure, "or similar proceedings" in a federal or state court.[24]

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Qualified Creditors

In recognizing that most often a loss corporation[25] in bankruptcy only has to offer creditors future equity interests in the reorganized company, a distinguishing characteristic of (l)(5) is the treatment of certain creditors in relation to IRC §382's general rules.[26] The general effect of this treatment is to treat qualified creditors of the debtor loss company as if they were equity shareholders, thus counting towards the 50 percent ownership requirement discussed below.[27] As eluded to above, inclusion of qualified creditors for valuation purposes reflects the reality that these creditors are in control of the debtor corporation and are likely to have substantial equity stakes post-confirmation. Thus, provided that certain creditors will indeed be equity investors in the reorganized corporation, it is sound policy to count them for valuation purposes immediately before the ownership change.

The regulations enacted under (l)(5) instruct, however, that not all creditors are automatically afforded this enhanced position—only qualified creditors may be included towards the 50 percent ownership rules.[28] Specifically, qualified creditors must own qualified indebtedness, immediately before the ownership change.[29] In sum, qualified indebtedness comprises: 1. Debt owned by the same owner for a period not less than 18 months before the bankruptcy filing;[30] and 2. Debt arising in the ordinary course of the business and held by the same owner. [31]

16 Because creditors accepting equity stakes in the reorganized debtor in exchange for debt obligations are not counted in the value multiple of §382's general NOL limitation calculation, the surviving NOLs would be almost always minuscule given the "value" of the debtor if computed under the general rules in §382. (l)(5) addresses this issue for bankrupt companies by counting "qualified creditors" as equity owners, and (l)(6) addresses this point by increasing the value of a bankrupt company by the amount of COD resulting in a stock-debt swap.

17 For purposes of this paper, the author refers to IRC §382(l)(5) as "(l)(5)" and IRC §382(l)(6) as "(l)(6)."

18 Though the language in (l)(5) is broad enough to ostensibly include any ownership change occurring during a bankruptcy case, the regulations specify that the provisions of (l)(5) only apply to a transaction that is "ordered by the court or is pursuant to a plan approved by the court." Treas. Reg. § 1.382-9(a).

19 IRC §382(l)(5).

20 The general §382 yearly NOL limitation is computed in the following manner: value immediately before ownership change multiplied by long-term tax-exempt rate. IRC § 382(b)(1).

21 "Under the general [§382] rule of the [1986 Tax Act], no carryforwards would survive the acquisition of an insolvent corporation because the corporation's value immediately before the acquisition would be zero." S. Rep. 99-313 at 236.

22 IRC §382 (l)(5)(A)(i).

23 Treas. Reg. §1.382-9(a).

24 IRC §368 (a)(3)(A); as referenced in §382(l)(5)(G). The reference to state proceedings would include, for example, proceedings authorized by Del. Gen. Corp. Law §§102(b)(2), 302. Such provisions may prove more efficient than Title 11. Gordon D. Henderson & Stuart J. Goldring, *Tax Planning for Troubled Corporations*, 261 (2008).

25 *Supra* note 7 for definition of loss corporation.

26 Generally, IRC §382 counts stock, but not debt in computing value. ("Except as otherwise provided in this subsection, the value of the old loss corporation is the value of the stock of such corporation . . .") IRC §382(e)(1).

27 IRC §382 (l)(5)(A)(ii).

28 "Qualified creditors" are creditors who owned "qualified indebtedness" immediately before the ownership change. Treas. Reg. §1.382-9(d)(1).

29 Treas. Reg. §1.382-9(d)(1). (stipulating that the stock must be received not only as a result of being a qualified creditor and in full or partial satisfaction of qualified indebtedness).

30 Treas. Reg. §1.382-9(d)(2)(i)(A).

31 Treas. Reg. §1.382-9(d)(2)(i)(B).

"Old and Cold Debt"

The first category of qualified indebtedness comprises of debt that has been owned by the same owner for at least 18 months—colloquially termed "old and cold debt"— prior to the bankruptcy filing.[32] A duty imposed on the debtor corporation includes ascertaining whether a debt in question has been held for the requisite amount of time to be considered qualified.[33] What the regulations term as a "duty of inquiry" may be satisfied if the debtor company obtains a signed statement from the beneficial owner of the debt listing the amount of indebtedness and the length of time that debt has been owned.[34] A de minimis rule relieves debtors of this duty when the creditor in question is not at least a 5% shareholder after the ownership change, but only if the creditor does not otherwise notify the debtor they do not meet the requisite time requirements.[35]

Ordinary Course Debt

In the event the debt in question does not meet the 18-month requirement, it may still be deemed qualified if accrued in the "ordinary course."[36] A debt is classified as "ordinary course" for (l)(5) purposes if incurred "in connection with the normal, usual, or customary conduct of business."[37] The regulations set out commonly accepted examples of debt that will be afforded "ordinary course" classification including trading debt, tax liabilities and liabilities arising from tort or breach of warranty actions, to name a few.[38] In addition, certain bankruptcy-specific expenses are set out such as a claim arising upon the rejection of a "burdensome" contracts or leases if they arose in the ordinary course of the debtor's trade or business.[39] Correctly identifying qualified creditors is of paramount importance prior to seeking (l)(5)'s application as this group will likely compromise the majority of the 50% ownership requirement, the topic of the following section.

50 - Percent Ownership by Qualified Creditors and Shareholders

The NOL valuation rules of (l)(5) automatically apply if the qualified creditors and shareholders of the loss company own at least 50% of the value and voting power of its stock immediately before and after the ownership change.[40] Attribution rules taken into consideration to other parts of IRC §382 are not applicable in a (l)(5);[41] accordingly, ownership classification is more narrowly construed in an effort to curb abuse.[42] Additionally, specific attribution rules apply in (l)(5) which dictate that any stock option exercisable when the ownership change occurs is deemed exercised if such exercise will cause the debtor company to fail the 50% test.[43] Conversely, an option owned as a result of being a pre-change shareholder or qualified creditor will not be treated as exercised if such deemed exercise would result in post-change ownership of stock by a pre-change shareholder or qualified creditor.[44] In effect, the preceding option attribution rules operate against (l)(5) qualification with regards to the 50% ownership requirements.[45]

(l)(5) Consequences

Exclusion from §382's NOL limitation rules comes at a cost, and as the discussion below summarizes, these costs are potentially more inhibiting to NOL preservation than IRC §382's general limitation. In contrast to a yearly limitation provided in the IRC §382's general rules (as well as (l)(6)), the provisions of (l)(5) mandate a one-time reduction in NOL carryovers to be determined when the ownership change occurs. The (l)(5) NOL reductions occur in two stages: 1. The first reduction occurs when a portion of the debt that is converted to stock includes accrued interest;[46] and 2. The second reduction takes into consideration cancellation of indebtedness (COD) income resulting in a stock-for-debt swap. The post-change company also pays a price in the form of a time-restriction prior to subsequent ownership changes discussed in greater detail later.

Interest "Haircut" and COD Reduction

The first reduction in NOL carryovers provided for in (l)(5) comes in the form of the interest "haircut."[47] The loss company must reduce pre-change NOLs dollar for dollar by the amount of any interest deductions taken on debt that was converted into stock in the year of the ownership change and the three prior taxable years.[48] Effectively, this means that a deduction is disallowed for interest paid or accrued during the period which begins the first day of third tax year before the tax year in which the ownership change occurs.[49] This reduction is based in sound policy—the converted debt was in effect de facto equity, thus the accrued interest is better viewed as a non-deductible return on equity investment. However, IRC §382(l)(5)(C) provides that any interest on debt exchanged for stock which subjected the debtor's NOLs to the interest haircut is not included in the calculation of COD income produced by the stock-for-debt exchange.[50] Without this provision, the interest in question would reduce a debtor's NOLs twice, once resulting from the interest haircut, and again by inclusion in COD income resulting in a reduction in NOLs.[51] Additionally, the second reduction in NOLs comes via operation of IRC §108 and the COD rules.[52]

Continued on p. 28

32 *Supra* note 18.

33 Treas. Reg. §1.382-9(d)(2)(iii) ("The loss corporation must determine that indebtedness that the loss corporation treats as qualified indebtedness [other than ordinary course debt] has been owned for the requisite period . . ."

34 *Id.* ("The loss corporation may rely on a statement, signed under penalties of perjury, by a beneficial owner regarding the amount of indebtedness the beneficial owner owns and the length of time that the beneficial owner has owned the indebtedness.")

35 Treas. Reg. § 1.382-9(d)(3)(i).

36 Treas. Reg. § 1.382-9(d)(2)(iv).

37 *Id.*

38 *Id.*

39 *Id.*

40 IRC §382(l)(5)(A)(ii).

41 *See* IRC §382(l)(3)(A)("Section 318 (relating to constructive ownership of stock) shall apply in determining ownership of stock . . .")

42 Treas. Reg. §1.382-9(d)(1).

43 Treas. Reg. §1.382-9(e)(1).

44 *Id.*

45 Portfolio 790-2nd: Corporate Bankruptcy, Detailed Analysis, C. Change of Ownership — Attribute Limitations. (stating that operation of the attribution rules in (l)(5) effectively serve against qualification.)

46 IRC §382 (l)(5)(B).

47 *Id.*

48 *Id.*

49 This rules applies to reduce pre-change losses even if the debtor does not incur losses within this period. *See* Field Service Advice 200006004 (interest paid or accrued must be taken into account when reducing NOLs, "regardless of whether Taxpayer incurred any NOL during that period.")

50 Because the debtor already reduces their NOLs because of the interest haircut, it would be overly punitive to also take this amount into COD calculations which further reduce post-change NOLs. IRC § (l)(5)(C).

51 COD income resulting from a stock-for-debt swap is excluded from taxable income in exchange for attribute reductions. Included within tax attributes to be reduced by operation of the §108 are NOL carryforwards. §108 (b)(1), (2)(A).

52 *See generally* IRC §108.

Forecasting Corporate Failure: Understanding Statistical and Theoretical Approaches to Bankruptcy Prediction

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Bankruptcy prediction models are often employed by debtors', creditors', or trustees' experts in litigation to prove or disprove whether the company in question was, at a particular point in time, in default or expected to default. Prediction models have been applied in a wide range of court testimony, including evaluating unreasonably small capital tests in fraudulent conveyance claims, assessing the appropriateness of liquidation valuation approaches, and determining retrospective credit-worthiness. Additionally, the doctrine of deepening insolvency, whether as a cause of action or as a measure of damages, may provide potential opportunities for the application for bankruptcy prediction models in the future.

While many different kinds of prediction models exist, the vast majority can be classified into two categories: statistical and theoretical. Statistical models attempt to identify the most common symptoms exhibited by bankrupt companies, and then use this information to estimate the likelihood that a particular firm will go bankrupt in the future. Conversely, theoretical models predict bankruptcy by attempting to identify and gauge the factors responsible for the causes of bankruptcy. Understanding the strengths and weaknesses of these approaches is helpful when deciding which particular prediction model to apply in a bankruptcy setting.

Statistical Models: Identifying the Symptoms of Failure

Although most prediction approaches use some form of statistical analysis, purely statistical models are based on the notion that, regardless of the causes of failure, the symptoms of impending bankruptcy will manifest in the form of deteriorating financial performance. Therefore, evaluating the historical differences in the financial metrics between failed and surviving firms should be informative; these differences represent the symptoms of impeding bankruptcy, and firms currently exhibiting these symptoms are likely to become bankrupt in the future. Based on this premise, statistical models employ some form of statistical analysis – most often multiple discriminant analysis (MDA) or logit regression analysis – in combination with inputs from companies' financial statements to predict bankruptcy. Statistical models have dominated academic research to date, and account for almost two-thirds of all bankruptcy prediction models developed, and used, by researchers.[1]

MDA – a statistical technique similar to regression analysis – is applied to bankruptcy prediction in the following manner. After a historical sample of bankrupt and non-bankrupt firms is selected for evaluation, the model classifies all the firms in the sample into one of two categories – bankrupt or non-bankrupt – using a specific set of predetermined characteristics. These characteristics – specified by the researcher in advance – are typically financial ratios that yield themselves to comparability across firms (such as debt-to-equity or sales-to-assets, for example). Mathematically, the model estimates the best combination of ratios that most effectively discriminates between the bankrupt and non-bankrupt firms and then produces an equation that describes the boundary line separating the two groups. This equation can then be used to calculate a "discriminant score" for any company to determine if, based on its financial ratios, it is more similar to a bankrupt or to a non-bankrupt firm.[2] A closer look at a popular prediction model, Altman's Z-score, is helpful in illustrating the application of MDA in practice.

Developed in 1968, Altman's Z-score model is often credited as the first application of MDA to bankruptcy prediction in academic literature and is perhaps the best-known bankruptcy prediction model today. Most of the firms in the original sample – drawn from 1946 to 1965 – used to develop and calibrate the Z-score model operated in the industrial and manufacturing sectors. The initial pool of firm-level characteristics considered by Altman consisted of 22 financial ratios selected based on their relevancy to bankruptcy prediction, and included liquidity, profitability, activity, and leverage metrics collected one year prior to bankruptcy. The final combination of the five key ratios shown below was derived after the evaluation of various combinations of ratios; collectively, these five ratios had shown superior predictive ability. The final equation, now known as Altman's Z-score, was stated as follows:

$$Z = 0.012(WC/TA) + 0.014(RE/TA) + 0.033(EBIT/TA) + 0.006(MVE/TL) + 0.999(S/TA)$$

WC/TA	Working Capital/Total Assets
RE/TA	Retained Earnings/Total Assets
EBIT/TA	Earnings Before Interest and Taxes/Total Assets
MVE/TL	Market Value of Equity/Total Liabilities
S/TA	Sales/Total Assets

On a stand-alone basis, the Z-score itself does not provide information about the company's probability of bankruptcy; instead, it allows for classification based on a relative comparison

[1] M. Adnan Aziz & Humayon A. Dar, *Predicting Corporate Bankruptcy: Where We Stand*, 6 (1) CORPORATE GOVERNANCE: THE INTERNATIONAL JOURNAL OF BUSINESS IN SOCIETY 23-24 (2006).

[2] EDWARD I. ALTMAN & EDITH HOTCHKISS, CORPORATE FINANCIAL DISTRESS AND BANKRUPTCY: PREDICT AND AVOID BANKRUPTCY, ANALYZE AND INVEST IN DISTRESSED DEBT 239-240 (3d ed. 2006). *See also* Edward I. Altman, *Predicting Financial Distress of Companies: Revisiting the Z-Score and ZETA Models*, 1 JOURNAL OF BANKING & FINANCE 9-12 (1977).

of firms' financial profiles.[3] Based on Altman's research, the optimal threshold score – the boundary that most accurately separates the companies that went bankrupt from those that did not – is 2.675. A firm with a score that falls below this level exhibits characteristics similar firms that subsequently went bankrupt, and corresponds with an increased likelihood of bankruptcy within the specified time-frame. However, because firms with scores falling between 1.81 and 2.99 were more likely to be misclassified, Altman advocated using a more conservative threshold score of 1.81.[4] The model's predictive ability, which will be discussed in more detail, is strongest when forecasting failure within a one-year time period. The model has been updated in subsequent years, including versions for non-manufacturing companies and non-public firms.[5]

Although not as popular in mainstream usage, conditional logit analysis – a type of regression analysis – is another well-researched statistical method often used for bankruptcy prediction. Logistic regression, as it is also known, is used to estimate the statistical relationship between specified variables and the probability of a particular outcome. Financial ratios and metrics are used as the primary inputs into the model, but unlike MDA, the output is an actual estimate of the probability of bankruptcy within a given time period. Proponents of this approach argue that logit analysis is better suited to the task of bankruptcy prediction because it requires fewer statistical assumptions and its output is easier to interpret.[6] In practice, however, the predictive ability of the two types of models is roughly equivalent.

Theoretical Models: Identifying the Causes of Failure

Unlike the symptom-focused approaches of the statistical models described above, theoretical models attempt to predict bankruptcy by focusing on the causes of failure. One well-known example, the contingent claims approach, has gained prominence due to its commercial use by firms like Moody's, Morningstar, and JP Morgan to provide credit-risk analysis for their clients. This approach is based on the view that past information, as depicted in financial statements, may have little bearing of the company's future performance. Instead, the information derived from market-based, forward-looking factors, such as stock price and firm valuation, may provide a better prediction estimate.

The contingent claims approach was popularized by the Expected Default Frequency (EDF) model developed by the KMV Corporation (later acquired by Moody's). The theoretical concept underpinning this model is that when a firm's market value of equity drops below a certain level relative to the book value of its liabilities, the firm will default on its debts (and, for all intents and purposes, will go bankrupt). The calculation behind this approach relies on the Nobel Prize-winning option-pricing theory developed by Black, Scholes, and Merton.[7] The assumption is that a company's equity can be considered an option, whereas the underlying asset is the sum of the company's assets and the strike price is the book value of its liabilities. Using a simplified scenario, an option becomes worthless if the value of the asset falls below the strike price; by extension, if the market value of the company's assets falls below the book value of its liabilities, the equity becomes worthless and the company will default. In theory, the expected probability of default can be calculated using the option-pricing formula with the market value and volatility of assets – derived from the firm's stock price – and the book value of its liabilities as inputs.

Compared with the rather straightforward application of the Z-score, the process for determining the probability of default for a particular company using the EDF model is complex. A number of inputs need to be determined before applying an option-pricing model. First, the expected market value of the company (and its assets) at a specified future date is calculated using the market value and historical volatility of its common stock. The next step is to establish the default point, or the level of assets relative to liabilities, at which a company will likely default. As discussed earlier, this default point is theoretically assumed to be at the level where the market value of assets falls below book value of liabilities. However, given the long-term nature of companies' balance sheet debt, the most frequent default point used in practice is the level where the market value of assets is approximately equal to the value of current liabilities plus one-half the amount of long-term debt.[8] Using the projected estimates of assets and liabilities, the so-called "distance to default" is calculated as the number of standard deviations from the expected market value to the default point. Lastly, a default probability is assigned based on the historical default rates of firms with similar distance to default measures. Because the model assumes that all of the relevant risk measures are included in the market value, default point, and asset volatility estimates, no adjustments for company size or industry are made. Although the model specifications and input calculations may vary, JP Morgan's CreditMetrics and Morningstar's Distance to Default models follow a similar approach.[9]

Although a variety of other theoretical models have been developed, few, if any, have proven to be as popular as the contingent claims approach. However, an area of research that has received attention from academics is the application of cash management theory to bankruptcy prediction. Intuitively, bankruptcy is the direct result of a firm's inability to pay down

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3 However, the "Bond Rating Equivalent" method can be used to produce an actual probability of default for a range of Z-scores. See EDWARD I. ALTMAN & EDITH HOTCHKISS, CORPORATE FINANCIAL DISTRESS AND BANKRUPTCY: PREDICT AND AVOID BANKRUPTCY, ANALYZE AND INVEST IN DISTRESSED DEBT 245-247 (3d ed. 2006).

4 Edward I. Altman, *Predicting Financial Distress of Companies: Revisiting the Z-Score and ZETA Models*, 1 JOURNAL OF BANKING & FINANCE 17-18 (1977); *See also* Edward I. Altman, *Financial Ratios, Discriminant Analysis and The Prediction of Corporate Bankruptcy*, 23 (4) THE JOURNAL OF FINANCE 606-609 (1968)

5 EDWARD I. ALTMAN & EDITH HOTCHKISS, CORPORATE FINANCIAL DISTRESS AND BANKRUPTCY: PREDICT AND AVOID BANKRUPTCY, ANALYZE AND INVEST IN DISTRESSED DEBT 240-243 (3rd ed. 2006).

6 James A. Ohlson, *Financial Ratios and the Probabilistic Prediction of Bankruptcy*, 18 (1) JOURNAL OF ACCOUNTING RESEARCH 109 (1980).

7 An option is a financial contract that gives the holder the right, although not the obligation, to buy or sell a particular underlying asset at a pre-specified price (the "strike price"); as such, the value of this contract is determined by several factors, including the strike price level, the value of the underlying asset and the volatility of the asset's value. Fischer Black & Myron Scholes, *The Pricing of Options and Corporate Liabilities*, 81 (3) JOURNAL OF POLITICAL ECONOMY 649-650 (1973); *See also* Robert C. Merton, *Theory of Rational Option Pricing*, 4 (1) BELL JOURNAL OF ECONOMICS AND MANAGEMENT SCIENCE 141 (1973).

8 EDWARD I. ALTMAN & EDITH HOTCHKISS, CORPORATE FINANCIAL DISTRESS AND BANKRUPTCY: PREDICT AND AVOID BANKRUPTCY, ANALYZE AND INVEST IN DISTRESSED DEBT 254-255 (3rd ed. 2006).

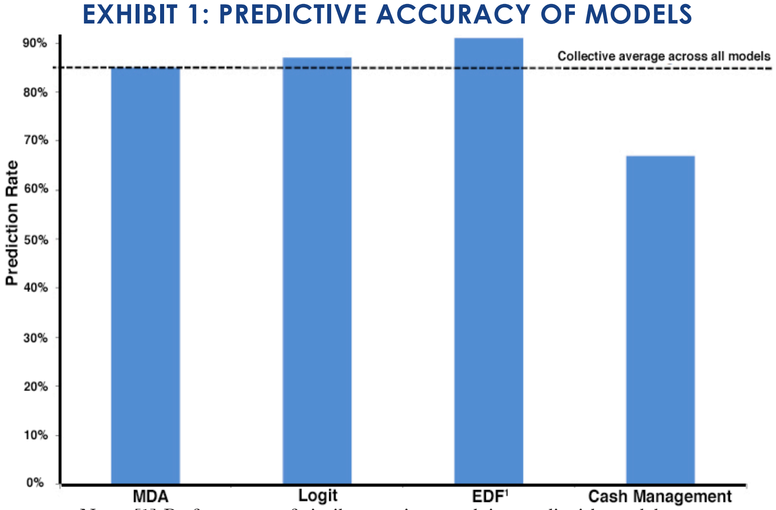
9 Richard H.G. Jackson & Anthony Wood, *The Performance of Insolvency Prediction and Credit Risk Models in the UK: A Comparative Study*, 45 (3) THE BRITISH ACCOUNTING REVIEW 16-20 (2013). EDWARD I. ALTMAN & EDITH HOTCHKISS, CORPORATE FINANCIAL DISTRESS AND BANKRUPTCY: PREDICT AND AVOID BANKRUPTCY, ANALYZE AND INVEST IN DISTRESSED DEBT 252-255 (3rd ed. 2006). Vahid Fathi, *Distance to Default*, in MORNINGSTAR CREDIT RATING METHODOLOGY 18-21 (2009). *See also* Warren Miller, *Comparing Models of Corporate Bankruptcy Prediction: Distance to Default vs. Z-Score* (2009) available at http://ssrn.com/abstract=1461704.

debt obligations as they come due. Therefore, it is reasonable to assume that current and predicted cash inflows and outflows should be strong indicators of impeding failure. Firms that are in distress, and are headed for bankruptcy, should have substantially different cash management behavior relative to their peers. Prediction models of varying complexity have been developed to evaluate cash flow behavior and test its predictive ability. Some researchers have employed economic demand models to describe the determination of optimal cash balances by firms and to model and predict cash management behavior.[10] Others have instead focused on simply using cash-flow variables as inputs for traditional statistical models.[11] However, as discussed in the section below, the usefulness of cash management theory as a predictor of bankruptcy remains unclear.

Predictive Performance

So how well do the models actually fare in practice? When discussing performance, it is easy to fall into the trap of focusing only on the ability of a particular model to accurately predict the firms in the sample that eventually went bankrupt – or its predictive accuracy. However, it is also useful to consider the number and type of erroneous predictions that arise as a result of misclassifications. These erroneous predictions can occur in one of two ways: a firm that is predicted to survive that actually goes bankrupt (known as a "Type I" or "false positive" error), or a firm that is predicted to go bankrupt that actually survives (known as a "Type II" or "false negative" error). These two types of errors are intuitively related – trying to specify a model to have more predictive accuracy in identifying firms that will fail may sometimes lead to more non-failing firms misclassified as likely to declare bankruptcy (and vice versa). Depending on the context in which the model is being used, a high incidence of either type of error may undermine the model's credibility and applicability. In addition, objectively evaluating a model's historical performance is a challenging task; a variety of factors such as the sample of companies used, the time period under evaluation, and the model's specifications can potentially influence the results from one study to the next.

EXHIBIT 1: PREDICTIVE ACCURACY OF MODELS

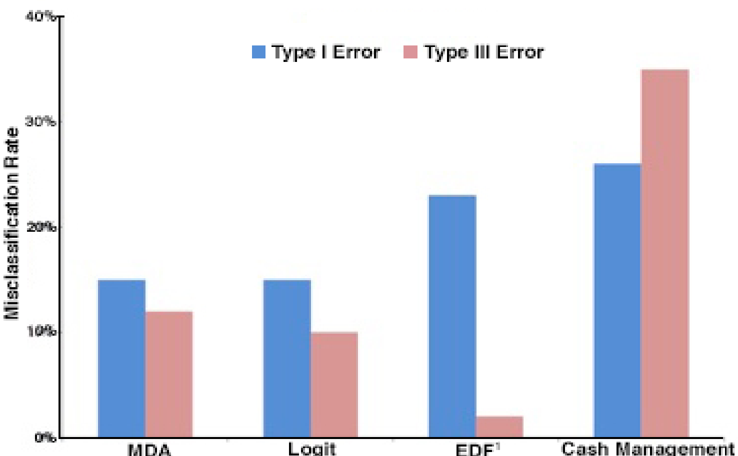


Note: [1] Performance of similar contingent-claim credit risk models shown due to lack of publicly available EDF model performance data.
Source: Aziz and Dar, 2006

A comprehensive academic study evaluating existing academic research on bankruptcy prediction provides some indication of the predictive abilities of the models previously discussed.[12] The authors of this research examined 89 empirical studies of bankruptcy prediction and found a collective average predictive accuracy of approximately 85 percent within one year of bankruptcy. MDA and logit analyses have averaged approximately 85 and 87 percent predictive accuracy, respectively (see Exhibit 1). Although the performance results of proprietary methods like the EDF model are difficult to obtain, some publicly available studies have indicated predictive accuracy as high as 91 percent for similar credit-risk models.[13] Relative to other models, MDA and logit models appear to be quite consistent when the predictive accuracy is adjusted by the variance of results across studies; however, it's worth considering that these models have been employed in a greater number of studies than any of the other models.

As shown in Exhibit 2, MDA and logit analyses fare somewhat better with respect to Type I errors (the number of firms predicted to survive that fail), while credit-risk models perform better with respect to Type II errors (the number of firms predicted to fail that survive).

EXHIBIT 2: MISCLASSIFICATION RATES OF MODELS



Note: [1] Performance of similar contingent-claim credit risk models shown due to lack of publicly available EDF model performance data.
Source: Aziz and Dar, 2006

Model Limitations

Given the inherent challenges of bankruptcy prediction, it is not surprising that all types of models are susceptible to criticism in one form or another. The availability of usable data is severely restricted by the relative infrequency of bankruptcies and the need to focus on publicly traded companies for data availability reasons. Statistical biases and inconsistent estimates can sometimes arise as a result of the small sample sizes used to develop a particular model. In addition to these broad challenges, academic proponents of one type of statistical approach are often critical of competing approaches for various methodological reasons. Likewise, theoretical approaches are not immune from similar challenges – for example, many academics and practitioners have questioned the assumptions behind the option-pricing theory, which is used as the basis for contingent claims models. Every approach has shortcomings that leave its ultimate validity open to debate.

10 Erkki K. Laitinen & Teija Laitinen, *Cash Management Behavior and Failure Prediction*, 25 (7) JOURNAL OF BUSINESS FINANCE & ACCOUNTING 893-919 (1988).

11 Abdul Aziz et al., *Bankruptcy Prediction: An Investigation of Cash Flow Based Models*, 25 (5) JOURNAL OF MANAGEMENT STUDIES 419-437 (1988).

12 M. Adnan Aziz & Humayon A. Dar, *Predicting Corporate Bankruptcy: Where We Stand*, 6 (1) CORPORATE GOVERNANCE: THE INTERNATIONAL JOURNAL OF BUSINESS IN SOCIETY 23-26 (2006).

13 *See*, e.g., Sreedhar Bharath & Tyler Shumway, *Forecasting Default with the Merton Distance to Default Model*, 21 (3) THE REVIEW OF FINANCIAL STUDIES 1339-1369 (2008).

The reliance on financial ratios as inputs – in any type of model – has been scrutinized primarily because of their endogeneity. Because the use of financial ratios is so widespread among company managers and investors, the detection of an adverse ratio measurement may push management to adjust their course of action in order to avoid financial distress or bankruptcy. In these cases, an adverse ratio can become the catalyst for positive change instead of the harbinger of failure, and thus undermine the predictive power of the ratio. Lenders also focus on financial ratios when assessing whether or not to extend credit, and breaching a specified ratio level may result in the company violating a loan covenant. Thus, financial ratios can also become a cause of bankruptcy, again undermining their predictive power. Additional concerns surround the propensity of financial statements to accurately convey the value of the underlying assets and liabilities. Because of the increase in the prevalence of intangible assets, such as assets tied to R&D-based technological innovation for example, there is some concern that the use of financial ratios overlooks important information. Likewise, the increased use of off-balance sheet financing and derivatives may distort true leverage levels, thus undermining the accuracy of the information gleaned from these ratios. However, the fairly recent implementation of Financial Accounting Standards Board (FASB) standards on fair value accounting may help to bolster the predictive ability of financial ratios if the standards help to address some of the aforementioned issues.

Models vs. Market Instruments

Given the limitations of prediction models, do market-based indicators such as bond yields and credit default swap (CDS) prices provide a better approach for bankruptcy prediction? While it is possible in theory to estimate the implied default probabilities from bond yields or CDS spreads, this approach offers its own unique set of challenges. The market price of publicly traded debt can be used to infer the probability of default that is expected by investors, but the approach is conditional on knowing, among other things, investors' recovery expectation in case of default. In practice, it is difficult – if not impossible – to isolate the default probability in bond prices from other factors impacting prices, such as supply/demand imbalances, risk appetite, liquidity, and other structural market factors that influence traded securities. Deriving implied probabilities from CDS spreads is equally problematic. For example, a 2011 study by Fitch Ratings concluded that the extreme volatility of the implied default probabilities calculated from CDS spreads limits "their usefulness as gauges of medium-term credit risk" and that various factors unrelated to the subject company, such as counterparty risk and margin account leverage availability, often drive CDS pricing.[14] When available, information from market instruments is likely a complement to, not a substitute for, other bankruptcy prediction methods.

Use of Bankruptcy Prediction Models in Litigation

It is worthwhile to explore how bankruptcy prediction models have fared in practice, specifically within the context of bankruptcy-related litigation. Given the prevalence of statistical models generally, and the popularity of Altman's Z-score specifically, it is not surprising that this approach is frequently cited in litigation matters. The courts have been decidedly mixed regarding the applicability of the Z-score. In *In re R. Richard Riso; Dahar v. Beatrice Riso*, plaintiff's expert used Altman's Z-score as justification for valuing Maybrook Corporation – a contested asset – on a liquidation rather than a going concern, basis.[15] He argued that because the Z-score classified the company as very likely to fail, no value should be assigned to any intangible assets. The court disagreed with the applicability of the Z-score in this context, citing the "lack of reliability of the Z-Score as a valid predictor" for companies, like Maybrook, with fewer than $1 million in total assets. The court referenced Altman's own published admonition that smaller firms had been excluded from the analysis due to lack of data. The court also noted that, bankruptcy, as predicted by the model, does not necessarily imply that a firm will be liquidated in light of the rehabilitative nature of Chapter 11.

In *In re Best Products*, a creditors' expert used the Z-score in attempt to prove that the company in question was left with unreasonably small capital in the wake of a leveraged buyout.[16] Although the expert showed that Best's Z-score was within the range of firms that failed during the period, the court noted that the model may not be relevant to non-manufacturing firms (which were used to develop the initial version of the model), and that a more updated version of the model would have been more appropriate. It is useful to note that Altman did develop an alternate model specifically to address companies in non-manufacturing sectors – one of the major differences in the updated model is the removal of the sales to total assets ratio as a predictive coefficient given the wide variance in firms' capital turnover across industries.

In *Vincent Difelice v. US Airways*, the court criticized the model for not taking into account "factors affecting the probability of bankruptcy that are not reflected in a company's financial statements" on the basis that financial statements, as historical metrics, don't address the possibility of future events, such as capital infusions and government bailouts.[17] As such, according to an opposing expert, fiduciaries typically rely on credit rating agencies to estimate the likelihood of bankruptcy instead. However, it is useful to note that rating agencies have themselves been faulted by investors for failing to adjust to adverse developments in companies' financial or economic circumstances in a timely manner.

Conversely, several courts have looked favorably on the use of the Z-score. In *NWF v. US Environmental Protection Agency*, the court's opinion rejected several similar objections levied against the Z-score.[18] NWF had argued that the "EPA's use of the Altman model is arbitrary and capricious because (1) the model has become outdated since its adoption in 1968, (2) it was devised to predict bankruptcies of companies smaller than those involved here, (3) it has an error rate of at least 15% and (4) in applying it, EPA collected data from only a single year." The court confirmed that research had shown the model's "continuing reliability" over time, its efficacy in prediction for large companies, and that multi-year data, although recommended, is not always necessary. Perhaps most notable was the court's finding that the 15% inaccuracy rate "does not seem so large as to call into question the model's reliability, especially given that the decision to enter bankruptcy vel non can be influenced by factors other than mere financial distress." This finding would appear to be broadly relevant given that – as discussed earlier – the collective average accuracy rate across bankruptcy models has been estimated to be around 85 percent.

14 ROBERT J. GROSSMAN & MARTIN HANSEN, CDS SPREADS AND DEFAULT RISK: INTERPRETING THE SIGNALS 2-6(2010).

15 *In re R. Richard Riso; Dahar, Trustee v. Beatrice Riso* (US Bankruptcy Court New Hampshire, 84-340, adv. no. 84-104).

16 *In re Best Products* (US Bankruptcy Court New York Southern District, 91-10048) p. 85.

17 *Vincent Difelice v. US Airways* (US District Court Virginia Eastern District, 04cv889) p. 34.

18 *National Wildlife Federation v. United States Environmental Protection Agency*, 980 F.2d 765, 16 (1992).

Lastly, the EDF model was referenced in *Mitsubishi Power Systems v. Shaw Group et al.* and *Newby et al. v. Enron et al* to highlight the impending bankruptcy of the firms in question.[19] In *Enron*, the opposing expert questioned the applicability of the model given that the key factors driving the EDF calculation – the value of assets and liabilities, as well as the firm's level of business risk – were purportedly manipulated by management. It was also noted that the prediction of default and bankruptcy based on this methodology can be calculated and interpreted in a variety of ways. For example, Moody's/KMV default probability estimates for a particular firm are based on historical averages derived from a proprietary database containing default data for several thousand firms. Alternative approaches, such as the use of forward-looking statistical probability distributions, can also be employed and may produce a different default prediction, despite the application of the same underlying theory. As with previous examples, neither approach is without merit.

Conclusion

Although they address the Z-score and EDF models specifically, the court opinions in the case examples are broadly relevant to all types of prediction models. Despite the differences in approaches and methodologies, all prediction models attempt to answer the same question: at a certain point in time, how likely is a particular company to go bankrupt? Because of differences in rationale, effectiveness, and applicability, each model is uniquely suited to answer this question. As such, the applicability and validity of any approach will always depend on the context and the details of the particular case.

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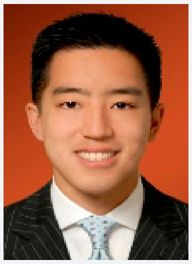

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19 *Mitsubishi Power Systems v. The Shaw Group et al.* (US District Court New York Southern District 04cv1251). Enron Corporation Securities Derivative & ERISA Litigation; *Newby et al. v. Enron et al.*; *The Regents of the University of California et al. v. Lay et al.* (US District Court Texas Southern District 01-3624, MDL-1446).

Bankruptcy Taxation

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SECTION EDITOR

Claim of Right Doctrine Can Save Taxes

The little known "claim of right" doctrine found in Internal Revenue Section 1341 can help taxpayers as illustrated by a recent panel discussion. When a taxpayer has to repay amounts which he included in income in a prior year, under the right circumstances, the taxpayer computes the tax refund in a way to maximize the amount of the refund. Example: Joe receives a fee of $10,000 for services rendered in 2013 but in 2014 a court rules that the services were deficient and Joe has to repay the $10,000 to the client. His marginal tax rate was 35% in 2013 and 25% in 2014. When Joe deducts the repayment in 2014 he will be able to reduce his tax at 35% on the $10,000.

Conditions for the Application of Section 1341

Payments received under a claim of right are includible in income even though it may be discovered in a later year that the individual had no right to the payment and is required to repay the same amount. The taxpayer must deduct the repayments in the year in which they are made. However, if the marginal tax rate is higher in the year of repayment, the taxpayer simply uses that tax rate. Code Section 1341 alleviates the potential inequity caused by timing differences. The amount repaid must exceed $3,000 and the taxpayer must have included the item in income under a legal claim of right in the original year. The circumstance causing repayment must stem back to the original year and cannot be an event taking place in a subsequent year (more on this below). Unfortunately, in certain circumstances, the Section 1341 deduction does not apply to alternative minimum tax, so this should be considered in optimizing the taxpayer's tax reduction.

In compensation repayment cases, it is extremely important to fall within Section 1341, as otherwise, the employee must claim a "miscellaneous itemized deduction" which would be subject to the 2% of AGI limit and no deduction is allowed for alternative minimum tax purposes.

Agreements to Repay

There is a split of authority concerning whether Code Sec. 1341 applies to situations where, under an agreement or corporate by-laws, the officer-stockholders of closely held corporations are required to repay any compensation subsequently determined by the IRS to be nondeductible by the corporation as a business expense. Such agreements are commonly used in closely held corporations to avoid treatment of the nondeductible item as a dividend. In Rev. Rul. 67-437 the IRS said that the event causing repayment was a subsequent event, i.e. the IRS audit took place in a later year. However, the U.S. Court of Appeals for the Sixth Circuit has held to the contrary. It determined that such a restriction on the taxpayer's right to the income imposed by an agreement to repay did not affect the availability of a Code Sec. 1341 adjustment. The fact that the taxpayer's ultimate right to the compensation was not determined until the occurrence of the subsequent event did not mean that the taxpayer had no unrestricted right to the compensation when he received it (E. Van Cleave, 83-2 ustc ¶9620)

Clawback Cases

Bloomberg BNA reports that panel members at a recent Tax Executive Institute conference discussed several scenarios in which employees might attempt to claim the Section 1341 deduction in the case of a clawback. Clawbacks are recouped compensation paid to an employee because of a violation of contract or law. For example, as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act, subject corporations must have a policy requiring executive bonuses based on earnings must be repaid if new data show the original earnings statement was erroneous. Does such a clawback then qualify for Section 1341 treatment since deficiencies in earnings reported do not usually come to light until a later year? The IRS has not yet enunciated a clear position on the Sarbanes-Oxley and Dodd-Frank clawbacks. Many of those incidents and cases are probably now wending their way through the courts.

Commentary

Section 1341 creates a natural tension as the taxpayer must apparently be entitled to the income in the year received, but the "title defect" must also be present in that same year. As a first impression, Dodd-Frank clawbacks of executive compensation based on corporate earnings should qualify under Section 1341 unless the executive knew about the defect. According to modern accounting theory, each year's financial statements (and any financial audit), should stand on its own even though estimates must be used for certain amounts. Therefore, the executive's entitlement to the earnings based compensation should be established. Likewise, any subsequent discovery of an error in the amounts or estimates used would then implicate the financial condition of the corporation in the year in question.

IRS Proposal Would Eliminate Many Debt Discharge Controversies

The Internal Revenue Service has proposed to delete the controversial 36 month rule for reporting of debt discharge by financial institutions and other lending businesses. Since 1996 the rules regarding reporting of debt discharge on Form 1099-C for cancellation of debt have followed the familiar "identifiable event" tests established by the courts for debt discharge—compromise of the debt, legal impossibility of enforcement, etc. The IRS rules also include an arbitrary requirement to issue Form 1099-C after 36 months of no action by the debtor or creditor. This 36 month rule led to a lot of legal controversies over whether the debt was actually discharged.

If the proposed deletion goes through, the issuance of Form 1099-C will be conformed to the common law tests for identifiable events of discharge and no arbitrary time period such as 36 months will apply. (REG-136676-13)

IRS Collections Suffers Two Setbacks in Tax Court

In two Tax Court cases in the last year, taxpayers won victories over the Internal Revenue Service Collections division which may set precedents which may help other tax debtors:

In *Eichler v. Commissioner*, the taxpayer had filed a request for an installment payment agreement on delinquent taxes before the IRS sent the taxpayer a notice of intent to levy because the request had not yet been entered into the IRS computer system. The court held the levy could not be attached until the pending request for the installment agreement was heard. However, the court went on to hold the notice of levy was valid even though there was a pending installment agreement because the IRS may take actions other than a levy to protect the interest of the government. A notice of levy is an action other than a levy to protect the government; it is merely preliminary to a collection action. The court refused to allow the taxpayer to make the IRS settlement officer (SO) follow the Internal Revenue Manual because those provisions do not carry the force and effect of law or confer rights on taxpayers. The taxpayer also objected to the SO's determination requiring the taxpayer to make a down-payment as a condition for his installment agreement but that issue was remanded to Appeals Division. (U.S. Tax Court, Dkt. No. 725-12L, 143 TC —, No. 2, July 23, 2014.)

In *Bogart v. Commissioner*, the court held that an IRS Appeals officer, during a Collection Due Process hearing, abused his discretion in rejecting an offer in compromise (OIC) based on effective tax administration (hardship) because he failed to adequately consider public policy and equity issues. The taxpayers, a married couple that operated an S corporation, agreed that the assessed tax liabilities were correct but submitted a proposed effective tax administration OIC on the basis that their tax problems stemmed from the criminal conduct (embezzlement) of their former bookkeeper. The court ruled that Appeals officer was not obligated, as a matter of law, to accept the ETA OIC but also ruled the Appeals officer improperly failed to give any consideration to the public policy and equity grounds alleged by the couple. At trial, the IRS contended that the taxpayers' circumstances did not conform to the examples provided in the regulations. However, the court said those examples are not the exclusive circumstances under which the IRS may accept an OIC for public policy or equity reasons. The case was remanded for further consideration by the Appeals office. (U.S. Tax Court, Dkt. No. 4568-12L, TC Memo. 2014-46, March 18, 2014.)

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

ABOUT THE AUTHOR

FORREST LEWIS, CPA

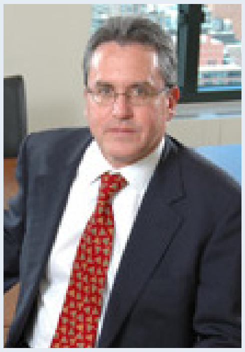
Forrest Lewis, CPA, is a retired tax partner of Plante Moran, PLLC, a regional accounting and consulting firm, working primarily on large corporate and bankruptcy cases. After receiving a Bachelor's Degree in Economics from the University of Michigan, he joined a predecessor of Plante Moran in 1974. Among the bankruptcy cases he worked on were Enron, General Motors, Genuity, Cable & Wireless, IT Group, Tronox, Bearingpoint and Energy Conversion Devices. Forrest has served as Tax Section Editor for AIRA Journal since 2006. This will be Forrest's final column in the Journal due to retirement as the AIRA Section Editor. See the Executive Director's column on p. 5 for comments on Forrest's contributions.

AIRA Members in the News

José E. Mendoza, CIRA, to Serve on FINRA Neutral Arbitrator's Panel

The firm of Mendoza-Rivera, CIRA, CPA, PSC—Certified Public Accountants & Forensic Accountants, in San Juan, PR—proudly announces José E. Mendoza has been qualified by the National Arbitration and Mediation Committee of the Financial Industry Regulatory Authority (FINRA) as a Dispute Resolution Arbitrator, member of the Southeast arbitrators' panel. Mr. Mendoza's career encompasses positions with Deloitte & Touche and KPMG, and former finance vice president of Seguros Triple S, Inc. (member of the biggest insurance conglomerate in Puerto Rico). His current auditing and consulting practice provides services in the following areas: attestation, business reorganizations, insolvencies, litigation support and specialized services in the insurance industry. Mr. Mendoza holds a Bachelor in Business Administration - Accounting with honors from the University of Puerto Rico. In addition, he holds the following certifications: Certified Insolvency and Restructuring Advisor (CIRA), Certified Public Accountant (CPA), and Certified Internal Control Auditor (CICA).

Mr. Mendoza may be reached at: Mendoza-Rivera, CPA, PSC; PO Box 363031, San Juan, PR 00936 - 787.706.9370 (office direct). Email: cpajemendoza@gmail.com



AIRA Board Member Andrew Silfen Named Arent Fox New York Managing Partner

In February, Arent Fox LLP announced the appointment of Andrew I. Silfen to lead its New York office as Managing Partner. Mr. Silfen will take over the New York leadership post from partner Michael S. Blass, who is stepping down after having led the office's recent growth during his seven years in the position. Mr. Silfen is nationally known for his work on behalf of creditors' committees and indenture trustees and has extensive experience in financial restructuring, distressed situations, and bankruptcy issues. His practice includes counseling companies' boards of directors and management on insolvency matters, crisis management, and financial and operational restructurings. He is an officer and a member of the board of directors of the Association of Insolvency and Restructuring Advisors and the New York Institute of Credit's executive board.

Mr. Silfen may be contacted at andrew.silfen@arentfox.com; for more information, see http://www.arentfox.com/people/andrew-silfen#.VR2QzfnF-So

New CDBVs

Congratulations to the following members who recently earned the Certification in Distressed Business Valuation!

AARON AMES
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Aaron Ames is a CPA (Ohio) and Certified Professional Accountant (Ontario, Canada), as well as a CIRA and CDBV. He specializes as a CFO and CRO in turnaround positions where he has successfully refinanced and sold companies in a variety of industries including mining, cold storage, circuit board manufacturing, and entertainment. Aaron previously worked with Ernst & Young in Cleveland and Canada, and holds a Master's of Accountancy from Case Western Reserve University.

BRIAN ASBY
JHT Holdings
Long Grove, IL
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As Vice President / Strategy for JHT Holdings, Brian's focus includes business development and evaluation of other financial and strategic opportunities. He is a CIRA with 10+ years' experience in distressed corporate turnaround and transaction advisory services. His MBA in Analytical Finance and Management & Strategy is from Northwestern Univ. Kellogg School of Management.

CHRIS BROWN
SOLIC Capital Advisors, LLC
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Chris is a Managing Director at SOLIC Capital where he assists clients in executing financial and operational restructuring and opportunistically invests capital in distressed situations. His 20 years' professional experience includes analyzing, structuring and trading stressed and distressed debt investments, and managing special situation funds. Chris is a CIRA and has a BA in Economics from Univ. of Michigan and MBA from Univ. of Chicago.

MICHAEL COLON
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Mike is a Senior Relationship Manager for First National Bank Southwest. He is a CIRA with 20 years' experience in banking and consulting, with focus on restructuring and problem loan resolution. In addition to restructuring, Mike has served in hundreds of underwritings, syndications and new credit facilities including Energy & Natural Resources, Manufacturing & Distribution, Healthcare, Real Estate, Media & Telecom, and Transportation. He completed over 23 years' Army service a Logistics Officer; he earned a BBA from Colorado Mesa Univ. and MBA from Pennsylvania State Univ.

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Bill Haegele is a Partner with KPMG in San Francisco, CA, and has been a CIRA since 2003. Bill serves as KPMG's National Lead for their Bankruptcy Dispute Advisory Practice and provides consulting services and expert testimony in engagements involving creditor and debtor rights, solvency and plan feasibility, enterprise valuation, fraudulent conveyance actions, accounting malpractice, securities litigation and contract disputes. Also a CPA, Bill received a BS in Accounting from San Diego State University.

DALE LASH
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Dale Lash is Partner-In-Charge of RubinBrown's Business Valuation Services Group with over 20 years' experience in valuation services, including 8 years with the valuation services group of a Big Five accounting firm as Senior Manager in charge of financial valuation practice. He provides business and intangible asset valuation services to businesses in a variety of industries, including construction, manufacturing, energy, retail, entertainment, financial services, health care, and chemicals. Dale has a BS in Business/Finance from Cal State University, Northridge; MBA in Business/Corporate Finance, from Indiana University.

New CIRAs

Congratulations to the following members who recently earned the designation Certified Insolvency and Restructuring Advisor!

PURAV ADIECHA
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Purav is a Manager in Grant Thornton's Corporate Advisory & Restructuring Services (CARS) practice. He specializes in providing financial and operational restructuring, turnaround, crisis and interim management, process improvement, capital raise, M&A and transaction advisory services in complex situations for companies and their stakeholders, in and out of court. Purav has an MBA - Finance and Strategy, from Carnegie Mellon – Tepper Sch. of Business.

NIMI ALAGBA
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Nimi is an Associate in the Corporate Restructuring Group at Deloitte. His experience in Finance, Turnarounds and Restructuring includes bankruptcy administration, financial and operational restructuring, cost reduction processes, debt and equity research, industry research and financial statements analysis. He has an MBA (finance) degree from Monroe College, King Graduate Sch. of Business.

DAVID CHARLOT
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David is a corporate finance executive with 20+ years successful track record in complex, global companies from banking to industry; formative experience was at GM's New York Treasurer's Office in its finance leadership development program. He has a hands-on, cross-functional approach and record of developing and implementing clear, flexible and effective solutions.

JEFFREY DUNN
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Jeffrey is a Managing Director - Valuation & Restructuring Advisory, with the Capstone Advisory Group in New York. He is an experienced appraiser of business interests with specialization in restructuring advisory engagements and expert testimony. He also has broad exposure to corporate finance, accounting, bankruptcy, solvency, portfolio valuations and business strategy.

AIDA ESCRIBANO-RAMALLO
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Ms. Escribano-Ramallo has 10+ years' experience in corporate reorganization, turnarounds, crisis management, fraud and forensic accounting. Her practice focuses on register and structure investment vehicles, tax decrees and incentives under Puerto Rican law. She also has requested private letter rulings and negotiated closing agreements for clients with the PR Treasury Department.

FRANCISCO J. FELICIANO
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Francisco "Paco" Feliciano has over 25 years' hands-on experience in public accounting, finance and taxes, with emphasis in taxation, mergers acquisitions and debt financing. He began at PwC, served as Controller in Fortune 100 companies, was manager in accounting departments of Borden, Inc. and Exxon, and served as deputy executive director of the Property Tax Assessor agency in PR.

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Since January 2014, Chris has been a Senior Associate with McGladrey where he has served in Litigation Consulting and Financial Investigations. Prior to joining McGladrey, Chris was a Senior Associate with CBIZ MHM. He earned his Bachelor of Arts degree in Business Administration at Fordham University with concentrations in Accounting and Finance.

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Since June 2009, Steven has been a Partner with PwC in New York. He provides assistance to clients in strategic planning, complex debt restructurings, business enterprise valuation, preparation of turnaround and business plans, development of pro forma financial projections, cash flow and working capital management, and operational reviews, among others.

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Bill is a Senior Managing Director with Guggenheim Partners and General Counsel with Guggenheim Investments. He is a senior legal, investment, and business-management executive with demonstrated ability to engage thoughtfully and drive value in numerous dimensions. Prior to joining Guggenheim, he served as an international tax advisor with Ernst & Young in Frankfurt, Germany. He holds a JD degree from University of Richmond and an AB in Philosophy from the College of William & Mary.

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Michael is Senior Vice President of Powerlink Transmission Company and Chairman of the Board with Coda Octopus Group (London, UK). He has extensive experience in the energy industry of the US, UK and Canada including Director of Gradient Resources, Inc., and Board member of MXEnergy, Inc., among others. Michael has also served as Sr. Managing Director with FTI Consulting, Inc., and is a retired Audit Partner with PwC.

MONSITA LECAROZ-ARRIBAS
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Ms. Lecaroz-Arribas is an Assistant U.S. Trustee for the District of Puerto Rico, in San Juan, PR. She received a BA degree from Duke University and a JD from the University of Puerto Rico.

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Scott's 20 years' experience in the US, Asia and Europe has focused on maximizing value for investors and creditors in distressed assets. Most recently he was trustee of cross border companies with complex claims in multiple jurisdictions. Earlier, he was an associate in with Simpson, Thacher & Bartlett and Cadwalader, Wickersham & Taft. He received JD and MA from Duke Univ., and BA from DePauw Univ.

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Under the COD rules, the NOLs of the pre-change company must be reduced by 50% of the amount of COD income generated in the stock-for-debt exchange.[53]

Two Year Holding Period

In addition to the interest haircut and COD reduction, an additional consequence of (l)(5) restricts subsequent ownership changes.[54] If a subsequent ownership change takes place following the ownership change which (l)(5) applied to, the limitation on the use of all of its NOLs—including the previously unlimited use NOLs—become worthless.[55] Accordingly, the post-change company has a keen interest in preventing ownership changes to occur via action by majority shareholder and activity on the various public exchanges. Further, although continuity of business is not a requirement in (l)(5)[56], the regulations provide that absent strong evidence to the contrary, an ownership change to which (l)(5) applies is considered to be made for the principal purpose of evasion or avoidance of tax unless the corporation carries on more than an insignificant amount of an active trade or business during and subsequent to the Title 11 or similar case.[57]

Defining "Ownership Change"

To breach the two-year holding period, the post-change corporation must endure an ownership change during the two year period immediately following the ownership change that triggered (l)(5)'s provisions.[58] An ownership change takes place if the percentage of the debtor's stock that is owned by 5% shareholders increases by more than 50% within the last three years or since the last ownership change, whichever is most recent.[59] The consequences of an ownership change are stark—as the debtor corporation is required to recalculate its NOL carryovers for the original ownership change in conformity with the general applicable formula (value of debtor's stock multiplied by long-term tax exempt rate.)[60] Furthermore, any NOLs earned between the first the second ownership change are entirely eliminated.[61] This consequence is particularly severe considering the value (or lack thereof) of a loss corporation's stock during the pendency of bankruptcy. Accordingly, it is of utmost importance for attorneys and tax practitioners to take proactive measures to prevent an ownership change from occurring during the ownership change testing period. The various strategies pursued by debtor's to prevent ownership changes from occurring, are discussed in greater detail starting on p.29 "Deciding Between (I)(5) and (I)(6)."

Section 382(l)(6)

Notwithstanding the flexibility provided via operation of the (l)(5) bankruptcy exception, the consequences enunciated above potentially outweigh the benefits for certain companies. For example, the two-year holding requirement may be too restrictive for acquirers not seeking to stick around for long, or the value of interest expense deductions may eliminate all pre-change NOLs after a stock-for debt swap. Moreover, not all bankrupt companies may be able to meet the 50% ownership requirement, thus disqualifying them from its application.[62] In these instances, the alternate NOL valuation route available to bankrupt companies codified in paragraph (l)(6) must be explored. As eluded to above, (l)(6) differs from (l)(5) in that there is no holding period exists, interest haircut or COD reduction; however, different limitations peculiar to this option potentially make (l)(5)'s consequences bearable.

(l)(6) provides that in the case of an ownership change resulting from a "G" reorganization or a stock-for-debt exchange in a title 11 or similar case, the value of the company for purposes of computing the annual NOL limitations shall be subject to general limitations imposed by §382(a)—but with special rules taking into account the particulars of bankruptcy.[63] As the general valuation rules of §382 lay the foundation for (l)(6)'s NOL yearly limitation computation, a brief recitation of those provisions is necessary.

In its most basic form, §382(a) calculates the yearly NOL limitation post-change by first multiplying the value of the debtor company by the long-term tax exempt rate.[64] For example, if the value of pre-change Corporation X is 100 and the long-term tax exempt interest rate equals 4.00%, the annual NOL limitation for the post-change company would equal 4. Accordingly, the post-change Corporation X would be limited to using NOLs with a value of 4 from pre-change operations against its post-change taxable income. However, if the amount of the limitation exceeds taxable income for any year, such excess is carried forward and added to the limitation in the succeeding taxable year.[65]

There are only two factors in the general NOL limitation formula: one related to value, the other representing the long-term tax-exempt rate.[66] As (l)(6) makes no adjustments to the tax-exempt rate, its differentiating characteristic from the general §382 formula relates to the valuation factor. Normally, in determining value outside of bankruptcy, §382 measures the value of the old loss corporation's stock immediately before an ownership

53 IRC §108(b)(1)(amount excluded in bankruptcy discharge shall reduce NOLs); §108(b)(3)(A)("reductions described in paragraph (2) shall be one dollar for each dollar excluded in subsection (a))

54 IRC §382 (l)(5)(D).

55 *Id.*

56 NOL carryforwards are generally disallowed "if the new loss corporation does not continue the business enterprise of the old loss corporation at all times during the 2-year period beginning on the change date . . ." IRC § 382 (c)(1), Treas. Reg. § 1.382-9(m) provides that the continuity of business requirement codified in §382 (c) and the regulations thereunder do not apply to an ownership change to which (l)(5) applies to.

57 Treas. Reg. § 1.269-3(d); *See also* Chief Counsel Advisory, IRS CCA 200444002, 2004 WL 2419338 (where the Service states that an acquisition in connection with an ownership change to which IRC §382(l)(5) applies is presumed to be a transaction with the principal purpose of evasion or avoidance of Federal income tax unless the corporation carries on more than an insignificant amount of an active trade or business during and after the bankruptcy case. The trade or business does not have to be the historic trade or business, however.)

58 IRC § 382(l)(5)(D).

59 IRC § 382(g).

60 IRC § 382(l)(5)(D).

61 *Id.* ("and the section 382 limitation with respect to the 2nd ownership change for any post-change year ending after the change date of the 2nd ownership change shall be zero.")

62 IRC §382(l)(5)(A)(ii).

63 IRC §382(l)(6)("If paragraph (5) does not apply to any reorganization described in subparagraph (G) of section 368 (a)(1) or any exchange of debt for stock in a title 11 or similar case (as defined in section 368 (a)(3)(A)), the value under subsection (e) shall reflect the increase (if any) in value of the old loss corporation resulting from any surrender or cancellation of creditors' claims in the transaction.")

64 The annual Section 382 limitation is intended to approximate the amount of income that the loss company could have produced as a return on equity, absent the acquisition, had it invested its capital in tax-exempt securities. *See* S. Rep. 99-313 at 233.

65 IRC §382(b)(2).

66 The long-term tax-exempt rate effective for May 2014 is 3.27%. Rev. Rul. 2014-13, Table 3. The long-term tax-exempt rate used is the highest of the adjusted federal long-term rates in effect for any month in the three-calendar-month period ending with the calendar month in which the change date occurs. IRC § 382 (f)(1).

change.[67] When a typical corporation is in bankruptcy, however, its stock usually has little value, thus application of this formula during an ownership change during a bankruptcy would be extraordinarily harsh to the new loss corporation.[68] To avoid this result, (l)(6) amends the general valuation standards to reflect any increase in value resulting from the cancellation of creditors' claims.[69] Specifically, the debtor corporation includes any increase stemming from COD following a G reorganization or stock-for-debt swap.[70] The regulations promulgated under (l)(6) elaborate on this rule by providing that the corporation's value under (l)(6) is the lesser of, 1. The value corporation's stock immediately after the ownership change[71]; or 2. The value of the corporation's assets before the ownership change.[72]

Despite the allowance for an increase in valuation related to COD income, the anti-stuffing still had the potential of severely limiting NOL preservation for bankrupt companies receiving capital contributions or payments from creditors to fund the plan. Treasury responded to this specific concern by including in the regulations an exception to the anti-stuffing rules for (l)(6) valuation purposes;[73] however, this exception only applies to contributions and/or investments subject to the "entrepreneurial risks of corporate business operation."[74] Furthermore, the continuity of business requirement codified in IRC §382(c) are fully applicable under the provisions of (l)(6).[75]

A Word on the Long-Term Tax-Exempt Rate

As the long-term tax-exempt rate is set with macro-economic conditions in mind, its percentage changes with the economic cycle. For companies outside the jurisdiction of Title 11 or not otherwise falling within the "similar case" provision, this reality is not as important to those companies considering between (l)(5) and (l)(6). For example, the adjusted long-term tax exempt rate for May 2014 is 3.27%,[76] a rate historically low compared with the long-term tax-exempt of just two decades ago which was 5.65%.[77] The current rate represents a greater limitation for companies electing (l)(6) than if a similarly situated company were to elect in 1995. For instance, a company with an (l)(6) valuation of $100 will be subject to a yearly NOL limitation of $3.27, while a company electing in 1995 would have a yearly limitation of $5.65. Over the course of 10-15 years and adding six or seven zeroes to this hypothetical, the difference in NOL utility is substantial. Consequently, the historically low current long-term tax-exempt limit the appeal of (l)(6) until the rate begins to rise again.

Electing Out of (l)(5)

Should a company decide that (l)(6)'s valuation maximize NOL preservation more so than (l)(5), the debtor company must make an election on a timely filed tax return for the year that includes the change date and that the election is irrevocable.[78] No election is necessary for bankrupt companies failing to meet the requirements of (l)(5), most likely due to an ability to meet the 50% ownership requirement.

Deciding Between (l)(5) and (l)(6)

In situations where the provisions of (l)(5) and (l)(6) are available to a bankrupt company, a thorough analysis is necessary in order to maximize NOL preservation. Failure to afford proper attention in electing between (l)(5) and (l)(6) may pose a great threat for post-change corporation's NOLs; accordingly, the benefits and consequences of each route must be weighed prior to a bankruptcy filing. To aid this process, the pros and cons between (l)(5) and (l)(6) can be separated into two categories, the dollar value of NOL preservation and business alienability considerations.

Maximizing NOL Dollar Value

In comparing NOL preservation, the mechanical computations are straightforward for both (l)(5) and (l)(6). With regards to (l)(6), after taking COD income into account in determining value, the loss corporation multiplies value by the long-term tax exempt rate to arrive at its yearly limitation.[79] The (l)(5) calculation requires few additional steps to take into account the interest haircut and COD income reduction. The following examples, imported from Norton Bankruptcy Law and Practice §158:15[80], demonstrate the mechanics, computations and, most importantly, total NOL preservation in a (l)(5)/(l)(6) comparison.

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67 "Old loss corporation" is defined as any corporation that has endured an ownership change and was a loss corporation prior to that ownership change. IRC § 382(k)(2)

68 "New loss corporation" is defined as "a corporation which (after an ownership change) is a loss corporation" IRC § IRC §382(k)(3).

69 IRC §382(l)(6).

70 *Id.*

71 Treas. Reg. §1.382-9(k) (Significantly, no anti-stuffing rule applies to the stock test, however, an anti-abuse rule excludes stock contributed with the principal purpose to increase the §382 limitation "without subjecting the investment to the entrepreneurial risks of corporate business operations")

72 Treas. Reg. § 1.382-9(l)(The asset test valuation under begins with the fair market value of the corporation's gross assets, without regard to liabilities, immediately before the ownership change; applies the anti-stuffing rule (and also treats as capital contributions any debt-financed acquisitions of cash or property intended to increase the value of the corporation); applies the nonbusiness assets rule by reference to substantiality of the corporation's nonbusiness assets held both before and after the change, and reduces the pre-change asset value by the value of the nonbusiness assets; does not apply the corporate contraction rule;1113 and applies the foreign corporation rule by taking into account only assets connected with the corporation's U.S. trade or business.

73 Treas. Reg. § 1.382-9(k)(4) ("[anti-stuffing rule] does not apply in determining value of the stock of the loss corporation for [(l)(6)] purposes.")

74 Treas. Reg. § 1.382-9(k)(6).

75 Treas. Reg. § 1.382-9(m)(2) ("If section 382(l)(6) applies to an ownership change of a loss corporation, section 382(c) and the regulations thereunder apply to the ownership change.")

76 Rev. Rul. 2014-13, Table 3.

77 Rev. Rul. 95-79, Table 3.

78 Treas. Reg.. § 1.382–9(d)(6)(ii).

79 IRC §382(b)(1), (l)(6).

80 The Norton Bankruptcy Law and Practice examples assume a long-term tax-exempt rate of 6.5%. I have adjusted the rate to reflect the long-term tax-exempt rate as of January 2014.

OPTION 1: EQUITY PLAN

Listed below is a summary of a confirmed plan where the creditors and debtor agreed to preserve as many NOLs as possible.

	Current Debt or Interest	Cash	Debt	Stock	(Percent)
Postpetition claims	25,000	7,500	17,500		
Accounts Payable	10,000		3,000		
Line of Credit	30,000		9,500	4,000	80
Long-term debt	10,000		7,500		
Common Stock	14,000			1,000	20
Retained Earnings	-20,000				
Total	69,000	7,500	37,500	5,000	100

Assumptions

Enterprise Value: 50,000
Liquidation Value: 20,000
Change of Ownership: More than 50%
Interest paid on debt discharge with stock in last three years: 5,500

382(l)(5) Scenario

NOL that will be preserved:

Total NOL carryforward		19,000
Less: Interest paid last three years	5,500	
Less: Gain on exchange of stock for debt times 50 percent [(45,000-22,500) x .5]	11,250	16,750
NOLs that will survive		2,250

382(l)(6) Election

Section 382 Limitation:

Value of reorganized equity x long-term exempt rate:

(25,000 x .0327) = 817.5

As a result of the creditors agreeing to accept a large part of their claim in the form of stock, the company is able to preserve its NOL carryovers and use annually about $817,500 of the NOL for the next 10 to 15 years. It is important to note that although the value of NOLs that will survive under the (l)(5) calculation is higher than the §382 limitation, a comparison this simplistic is severely is misleading. The 2,250 figure computed in the (l)(5) table represents the total NOLs that will be preserved from pre-change operations; however, the (l)(6) figure (872.5) merely represents the yearly limit.[81] Thus, assuming sufficient taxable income in post-change years, the (l)(6) option results in greater NOL preservation that of (l)(5). Because of this value, the creditors are often willing to take a larger percent of their claim in the form of stock ownership, which gives the company a much better financial structure on emerging from Chapter 11.[82] Deciding whether to elect out of (l)(5) is far simpler in the following example.

OPTION 2: DEBT PLAN

Listed below is a summary of a confirmed plan where the creditors and the debtor did not agree to preserve the net operating loss, but agreed primarily to take only debt in the reorganized company.

	Current Debt or Interest	Cash	Debt	Stock	(Percent)
Postpetition claims	25,000	5,000	20,000		
Accounts Payable	10,000			5000	20
Line of Credit	30,000			15,000	60
Long-term debt	10,000		5,000	2,500	10
Common Stock	14,000			2,500	10
Retained Earnings	-20,000				
Total	69,000	5,000	25,000	25,000	100

382(l)(5) Scenario

NOL that will be preserved:

Total NOL carryforward		9,500
Less: Interest paid last three years	5,500	
Less: Gain on exchange of stock for debt times 50 percent [(45,000-22,500) x .5]	8,250	13,750
NOLs that will survive		0

81 Additionally, any unused portion of the $872.5 in post-change years will increase the annual limitation in subsequent post-change years. IRC §382(b)(2).

82 8 Norton Bankr. L. & Prac. 3d § 158:15.

382(l)(6) Election

Section 382 Limitation

Value of reorganized equity x long-term exempt rate:

$$(5{,}000 \times .0327) = 163.5$$

An (l)(6) election is clearly advantageous given the numbers provided above. The value of the interest expense deductions taken over the previous three years, in addition to the COD income taken into consideration, results in the reorganized debtor reducing their NOL carryover to 0. Juxtapose this result with that of (l)(6) where despite the IRC §382 limitation, NOL preservation greatly exceeds that offered absent an election out of (l)(5).

Restrictions on Alienability of Interests

The two-year holding period imposed in (l)(5) requires corporations to contemplate beyond simple dollar value NOL preservation at the time of the ownership change and reflect on restraints on alienability accompanying such a commitment.[83] This contemplation is not limited to the activities of the majority shareholders (or those exerting control); rather, as the statutory definition of "ownership change" dictates, even the actions of shareholders with a relatively small share of ownership may trigger an ownership change.[84] A parsing of §382(g) quickly reveals the various forms of ownership change bankrupt companies must be wary of in order to remain in compliance with (l)(5)'s holding period.

As described above, an ownership change takes place if there is any change in the respective ownership of stock of a debtor and, after that change, the percentage of stock owned by any one 5-percent shareholder has increased more than 50 percentage points over the lowest percentage of stock owned by that shareholder during a three-year period.[85] If not for the inclusion of qualified creditors in the 50% post-change ownership requirement,[86] companies in bankruptcy would always trigger an ownership change due to operation of the absolute priority rule which often mandates the issuance of stock in satisfaction of creditors' claims.[87] While this outcome is avoided by (l)(5)'s particular treatment of qualified creditors , unrestricted claims trading may still limit the debtor's ability to confirm a plan that distribute at least 50% of the stock to shareholders and qualified creditors, thus threatening (l)(5) NOL preservation requirements.[88]

Additionally, an ownership change may be triggered if a substantial shareholder of the debtor takes a worthless stock deduction with respect to its debtors stock during the pendency of a bankruptcy proceeding.[89] A §382(g)(4)(D) ownership change takes place when a 50% shareholder of the debtor[90] treats the debtor's stock as becoming worthless and "such stock in held by such shareholder as of the close of such taxable year."[91] The most common way this form of ownership change occurs takes place is when a 50% shareholder claims a worthless stock deduction, as allowed under §165(g)(3).[92] Indeed, the threat of an ownership change by virtue of a 50% shareholder taking a worthless stock deduction gave rise to a landmark decision in *In re Prudential Lines*, holding the corporate debtor's right to use NOLs post-emergence from bankruptcy within the confines of property of the estate.[93] The holding in *In re Prudential*, discussed in greater detail below, would lay the foundation for future court-ordered trading restrictions in pursuit of protecting NOLs.[94]

In response to the threat posed to tax attributes in the event of an ownership change, companies have sought to regulate a wide range of trading activity during the pendency of a bankruptcy via court-ordered injunctions.[95] Though the exact form varies depending upon the risks present, the goal of the injunction is to prevent trading activity that may result in an ownership change.[96] Increasingly, debtors are including in their first-day motions requests to enjoin the purchase and sale of equity interests in the debtor that would effect an ownership change—commonly termed anti-trading injunctions—and courts have routinely granted them in many of the largest bankruptcies over the last

83 This contemplation is of utmost to the debtor corporation because if it fails to elect out of (l)(5) and undergoes a second ownership, following the ownership change that the (l)(5) applies to, within two years the limitation on the use of all of its losses — including the previously unlimited-use losses — becomes zero. IRC §382(l)(5)(D); Treas. Reg. § 1.382-9(n)(1).

84 IRC §382(g) contains the various transactions prompting an ownership change for §382 purposes.

85 For purposes of subsection (g), all shareholders owning less than 5% of the debtor's stock are aggregated and treated as one shareholder. IRC §382(g)(4)(A).

86 IRC §382 (l)(5)(A)(ii).

87 11 U.S.C.A. § 1129(b)(2)(B)(ii) (regarding treatment of unsecured claims for a plan to be confirmed.)

88 For an overview of NOL trading injunctions, *See* Michael A. Fagone, *Claims Trading Injunctions and Preservation of Nols*, Am. Bankr. Inst. J., February 2003; Bromley, *Protecting Trading Markets and NOLs in Chapter 11 24-Feb. Am. Bankr. Inst. J. 1*; and H. Jeffrey Schwartz, *Protection of Net Operating Losses Through Trading Injunctions and Forbearance*, 17 J. Bankr. L. & Prac. 6 Art. 7

89 IRC §382(g)(4)(D).

90 The term "50 percent shareholder" is defined as "any person owning 50 percent or more of the stock of the corporation at any time during the 3-year period ending on the last day of the taxable year" in which that stock was treated as worthless. *Id.*

91 *Id.*

92 Portfolio 790-2nd: Corporate Bankruptcy, Detailed Analysis, A. Potential Threats to Tax Attributes (explaining that although IRC §382(g)(4)(D) does not specifically reference worthless stock deductions triggering an ownership change, it is certainly the most frequent.)

93 *In re Prudential Lines, Inc.*, 928 F.2d 565 (2d Cir. 1991) (In *In re Prudential Lines Inc.*, the Second Circuit affirmed the bankruptcy court's injunction preventing the debtor's parent company, where the debtor was the parent's wholly owned subsidiary, from taking a worthless stock deduction, since it would have adversely affected the debtor's ability to carryforward its NOLs to offset future income. The Second Circuit held that the right to carryforward a tax deduction due to the NOLs attributable to the debtor's prebankruptcy operation was property of the debtor's bankruptcy estate.)

94 Though *Prudential Lines, Inc.* was the first case to resolve whether NOLs were in fact property of the estate, the Supreme Court held under the Bankruptcy Act (the precursor of the Bankruptcy Code enacted in 1978) that NOL carryback refunds were property of the bankruptcy estate. *See Segal v. Rochelle*, 382 U.S. 375 (U.S. 1966) (holding Bankrupts' loss-carryback refund claim based on losses in year of bankruptcy was sufficiently rooted in prebankruptcy past and so little entangled with bankrupts' ability to make an unencumbered fresh start that it should be regarded as "property" under section of Bankruptcy Act providing that trustee of estate of bankrupt shall be vested with title of bankrupt to property which prior to filing of petition he could by any means have transferred).

95 Fagone, *supra* note 88, at 46.

96 For example, the anti-trading injunction may be structured to prevent any 5 percent shareholder from increasing its ownership interest or to prevent any person from becoming a 5 percent shareholder prior to confirmation of plan.

three decades.[97] Because these injunctions restrict alienation of unsecured creditors' property, anti-trading orders have been at the source of litigation from disgruntled creditors.[98]

The bankruptcy court's authority to issue anti-trading injunctions traces back to the resolution of one contentious issue: Whether a corporate debtor's right to use NOL carryforwards constituted property of the estate under §541(a) of the Bankruptcy Code. Noting the value to the reorganized debtor of being able to offset future income by deducting NOLs, the Second Circuit held in *In re Prudential Lines* that "the right to a carryforward attributable to its . . . . NOL was property of [the debtor's] bankruptcy estate."[99] The court in *Prudential Lines* further held that, under the equitable powers conferred by 11 U.S.C. §105(a),[100] the provision granting the bankruptcy court equitable powers, the bankruptcy court has the authority to enjoin actions that may impede the debtor's reorganization.[101] Consequently, categorizing NOLs within property of the estate permitted courts to issue trading injunctions to protect often the most valuable asset in the debtor's estate—its NOLs. Citing *Prudential Lines* as their primary authority, debtors have been successful in persuading bankruptcy courts that certain claims and/or equity trading constitute an act to exercise control over the debtors' NOLs in violation of the automatic stay.[102] Of course, an election out of (l)(5) avoids the change of ownership dilemma entirely, as the two-year holding period does not apply under (l)(6).[103] This is precisely the argument creditors opposing the enforcement of anti-trading injunctions make when attempting to avoid this restriction.[104]

Despite not being subject to the ownership rules of (l)(5), (l)(6)'s provisions bear with it post-ownership change restrictions of its own. As mentioned above, the continuity of business requirement is significantly relaxed for companies proceeding under (l)(5)—the same cannot be said of companies under (l)(6).[105] The regulations provide that if "section 382(l)(6) applies to an ownership change of a loss corporation, section 382(c) and the regulations thereunder apply to the ownership change."[106] Violation of the continuity of business requirement reduces the yearly NOL limitation to zero for any post-change year.[107] Consequently, unless the post-change corporation is committed to maintaining the continuity of business for at least two years, electing out of (l)(5) may not be suitable.[108]

Conclusion

Though understanding the mechanics certainly assists, deciding between (l)(5) and (l)(6) is far more complex than simply adding, subtracting and multiplying. As the two-year holding period exemplifies, maximizing NOL preservation under (l)(5) is all for not in the event of a premature ownership change. Likewise, (l)(6)'s yearly limitations are only useful if the reorganized corporation has long-term taxable income to make use of them. Accordingly, the debtor and its attorneys, valuation experts and financial advisors must coordinate to ensure not only maximum *total* NOL preservation, but maximum NOL *utility* for the reorganized debtor.

97 *See, e.g., In re Russell*, 927 F.2d 413, 417–18 (8th Cir. 1991); *In re American Safety Razor Co., LLC*, No. 10-2351 (Bankr. D. Del. 7/30/10); *In re Lehman Bros. Holdings Inc.*, (Bankr. S.D.N.Y.); *In re General Motors Corp.*, Case No. 09-50026 (Bankr. S.D.N.Y.), *In re Washington Mutual, Inc.*, Case No. 08-12229 (Bankr. D. Del.); *In re Circuit City Stores, Inc.*, Case No. 08-35653-KRH (Bankr. E.D. Va.); In re Dana Corp., No. 06-10354 (Bankr. S.D.N.Y.), *In re Delphi Corp.*, No. 05-44481 (Bankr. S.D.N.Y.); *In re Calpine Corp.*, Case No. 05-60200 (BRL) (Bankr. S.D.N.Y.); *In re Delta Air Lines, Inc.*, Case No. 05-17923 (ASH) (Bankr. S.D.N.Y.); *In re Northwest Airlines Corp.*, Case No. 05-17930 (ALG) (Bankr. S.D.N.Y.); *In re U.S. Airways, Inc.*, Case No. 04-13819 (Bankr. E.D. Va.); *In re Enron Corp.*, Case No. 01-16034 (AJG) (Bankr. S.D.N.Y.); *In re UAL Corporation*, Case No. 02-B-48191 (ERW) (Bankr. N.D. Ill.); *In re U.S. Airways Group, Inc.*, Case No. 02-83984 (SSM) (Bankr. E.D. Va.); *In re Williams Communications Group, Inc.*, Case No. 02-11957 (BRL) (Bankr. S.D.N.Y.); *In re Kaiser Aluminum Corp.*, Case No. 02-10429 (JKF) (Bankr. D. Del.); *In re First Merchants Acceptance Corp.*, 1998 Bankr. LEXIS 1816, Case No. 97-1500 (JJF) (Bankr. D. Del.); *In re Southeast Banking Corp.*, Case No. 91-14561-BKC-PGH (Bankr. S.D. Fla.); *In re Phar-Mor, Inc.*, 152 B.R. 924 (Bankr. N.D. Ohio 1993). For a discussion of developments in this area, *see* Henderson & Goldring, *Tax Planning for Troubled Corporations*, §§508.2.4, 1002.4.1 (2010 ed.)

98 Fagone, *supra* note 88.

99 *In re Prudential Lines Inc.*, at 573. The Court reasoning for including NOL carryforwards within property of the estate was based significantly in the congressional objective of including anything of value with property of the estate. ("Finally, in determining the scope of § 541 we must consider the purposes animating the Bankruptcy Code . . . Including NOL carryforwards as property of a corporate debtor's estate is consistent with Congress' intention to "bring anything of value that the debtors have into the estate . . . Moreover, '[a] paramount and important goal of Chapter 11 is the rehabilitation of the debtor by offering breathing space and an opportunity to rehabilitate its business and eventually generate revenue." *Id."*

100 11 U.S.C.A. § 105(a) (grants the bankruptcy court power to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Bankruptcy Code].") Courts have since criticized using 11 U.S.C.A. § 105(a) as the legal basis for stock trading injunctions, arguing that Code § 105(a) was an enforcement provision, not an "independent source of substantive authority," and that Code § 362 only indirectly granted authority for these kinds of injunctions. *See In re UAL Corp.*, 412 F.3d at 778; H. Jeffrey Schwartz, *Protection of Net Operating Losses Through Trading Injunctions and Forbearance*, 17 J. Bankr. L. & Prac. 6 Art. 7

101 *Id.* at 574.

102 Fagone *supra* note 88.

103 If the provisions of (l)(6) apply to the first ownership change, the zero limitation imposed in (l)(5) does not apply. Additionally, any added value permitted to be taken into account under the IRC §382(l)(6) stock valuation rules that would not be permitted under the generally applicable rule of IRC §382(l)(1) need not be subtracted back out for purposes of the second-change valuation. Treas. Reg. § 1.382-9(n)(2).

104 *Id.*

105 Treas. Reg. § 1.382-9(m)(1) *supra* note 47.

106 Treas. Reg. § 1.382-9(m)(2).

107 IRC §382 (c)(1).

108 However, an ownership change to which (l)(5) applies is presumed to be a transaction with the principal purpose of evasion or avoidance of Federal income tax unless the corporation carries on more than an insignificant amount of an active trade or business during and after the bankruptcy case. The trade or business does not have to be the historic trade or business, however. Treas. Reg. § 1.269-3(d).

AlixPartners Survey Points to an Increase in Chapter 11 Business Filings[1]

NEW YORK (March, 2015) – AlixPartners, the global advisory firm, has released its Ninth Annual North American Restructuring Experts Survey and 2015 Outlook. Results of the survey indicate restructuring experts from across the US believe that following a cyclical decline in Chapter 11 business filings in recent years, the cycle may have bottomed and the market could be set for an increase in bankruptcies. In addition, the survey shows that the energy sector, both in the US and internationally, is expected to be an area with the greatest potential for restructuring activity in the year ahead. While Chapter 11 filings have decreased since 2009, 47% of experts surveyed predict an increase in the year ahead, while 31% expect no change.

Highlights of Survey Results

- 47% of restructuring experts surveyed believe that Chapter 11 filings will increase in 2015
- 53% of experts surveyed predict that pre-negotiated and pre-packaged bankruptcies will increase
- There is nearly unanimous agreement (99%) among respondents that the presence of non-traditional lenders and investors will continue to grow in the term loan market
- 74% of the experts surveyed view collateralized loan obligation (CLO) ownership as having a negative impact on restructurings
- Restructuring experts surveyed foresee the energy and resources sectors as the leading candidates for restructurings, in the U.S. (79%) and globally (78%), followed by the retail industry.
- The number of pre-negotiated and prepackaged bankruptcies has increased steadily since 2008. Experts tend to believe that this trend is here to stay, with 53% of experts surveyed expecting a further increase and 40% expecting no change.

The Outlook for Business Credit

In terms of expectations for the availability of credit for businesses and corporations, 41% of restructuring experts expect a tightening in the availability of revolving lines of credit and traditional bank loans, with 34% foreseeing no change. Consequently, an overwhelming majority (99%) of experts surveyed believe that the role of non-traditional lenders and investors will continue to grow in the term loan market.

Compounding the challenge for some companies facing restructuring situations, 74% of experts surveyed view that CLO ownership has a negative impact on restructurings. One possible explanation for this view is that borrowers with loans securitized into CLOs may find it more difficult to renegotiate or restructure their loans.

Global Restructuring Outlook

With global economies experiencing volatility, restructuring experts were asked where they see the greatest likelihood of corporate restructuring work in the year ahead. They answered that Western Europe (52%) and Latin America (37%) are the two regions with the greatest potential to generate restructuring situations, followed by Asia (24%) and Russia (19%).

Expectations for Industry Sector Vulnerability

When asked which industries are likely to face the most distress in 2015, respondents concluded that energy and resources was the top pick in both the U.S. (79%) and globally (78%), most likely due to the steep drop in commodity prices since June. Several energy companies are in the pipeline to be restructured, and the continued decline in energy prices was a major business story during the period when the survey was conducted, making it a top-of-mind issue for respondents.

Retail was the second pick in the U.S. (52%) and the third pick globally (29%). While retail is an industry that is always seen as ripe for restructuring—due to evolving consumer preferences and other factors—a key driving factor in recent years has been the rise of e-commerce, which continues to put pressure on traditional brick-and-mortar retailers.

Healthcare was third on the U.S. list (25%) but near the bottom of the global list (2%). In the U.S., the reforms of the Affordable Care Act, along with other changes, are upending established business models for healthcare companies, with restructurings likely to play out over the next several years. However, healthcare is run—or heavily regulated—by the government in most other countries, so the sector is far more stable in those markets.

Lessons from the Past

When asked who is to blame for repeat bankruptcies, respondents said they blame financial restructurings that are not deep enough (38%) and a company's operations not being adequately fixed the first time (32%). When asked about priorities for fixing the bankruptcy code, 27% of experts cited lease assumption/rejection deadlines and 22% cited extensions of exclusivity. Both of these point to the constrained deadlines within which debtors must work when in bankruptcy.

For senior leaders at companies that maybe on the brink, the margin for error that has existed over the past several years may be dwindling. Although prepackaged bankruptcies – often perceived as a quicker and less expensive way to restructure – are expected to grow, experts are wary of financial restructurings that are not deep enough and restructurings that don't adequately fix the underlying operating problems, causing some companies to take a second and third trip to the bankruptcy courts.

About the North American Restructuring Experts Survey and 2015 Outlook

The Ninth Annual North American Restructuring Experts Survey and 2015 Outlook, based on interviews conducted in late 2014 with 165 restructuring industry experts, highlights the evolving state of the restructuring industry and forecasts developments over the next 12 months. The survey polled senior attorneys, investment bankers, fund managers and other restructuring professionals across the United States about their outlook for the restructuring industry and related topics.

[1] This article is based on the original report copyrighted 2015 by AlixPartners, LLP. See http://www.AlixPartners.com/Survey2015

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Part 2 Aug 05-07, New York, NY

Part 2 Aug 10-12, San Juan, PR

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Part 3 Oct 01-05, San Juan, PR

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Part 2 Aug 25-28, San Francisco, CA

Part 3 Dec 08-11, New York, NY

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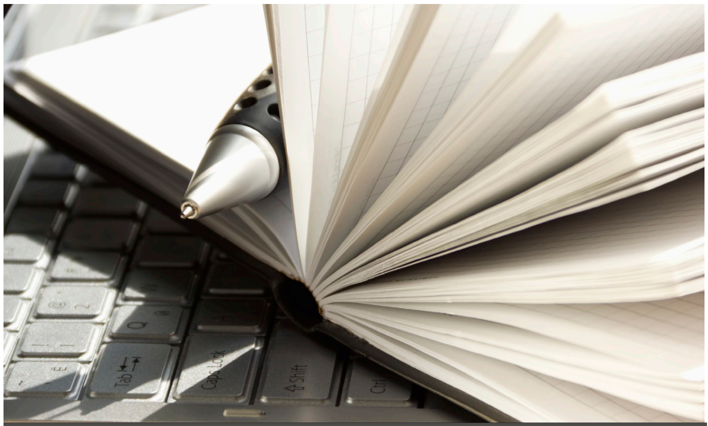

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Wednesday, April 22, 2015
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This one-hour presentation will describe current conditions in the government contracting industry and the particular negative impact on mid-tier government contractors.

More information www.AIRA.org

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