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From the
Executive Director's Desk

THOMAS MORROW, CIRA
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It is a great feeling when months of effort, coordination and hard work finally come to fruition. Leading up to the conference we were engaged in final preparations and anxious for June 8th to arrive and to welcome everyone to Coronado Island for the 32nd Annual Bankruptcy & Restructuring Conference! We were very fortunate this year to have a great planning committee led by Co-chairs Tom Jeremiassen, CIRA (Berkeley Research Group, LLC), Shirley Cho (Pachulski Stang Ziehl & Jones LLP) and Stacey Elledge Chiang, CIRA (Squar Milner); and we are especially thankful for the support and guidance of Judicial Co-chairs Hon. Margaret M. Mann (U.S. Bankruptcy Court, SD Cal) and Hon. Barry Russell (U.S. Bankruptcy Court, CD Cal).

In my opinion, the educational program was truly outstanding – an interesting mix from small practitioner topics, such as a panel on family-owned businesses, to significant current and industry topics including oil and gas, grocery stores and newspapers. We received very positive feedback that the topics were very relevant to the cases they were working on. Now our challenge is to match this year's quality next year at AC17 in Dallas.

I was glad to see many of you on Wednesday morning, June 8, to get things rolling with one of the information-packed Preconference seminars – Bankruptcy Taxation and Financial Advisors' Toolbox. The Bankruptcy Taxation track featured ten speakers who examined more than a half-dozen detailed bankruptcy taxation issues. The Financial Advisors' Toolbox track fielded 15 speakers covering current topics in restructuring, including Plan Support Agreements, pre-packaged plans and contested valuation hearings. I hope many of you enjoyed the dynamic luncheon presentation by Aaron McDaniel enlightening us about millennials.

Speaking of dynamic presentations, we had a 5.2 earthquake near San Diego at 1:00 am Friday morning, the same day Dr. Frank Vernon, a seismologist from Scripps Institute, was scheduled to speak at lunch. Dr. Vernon discussed the event in the context of the larger efforts he is leading to collect and analyze long term data on seismic activity, wildfires, tsunamis, and other natural disasters. How the planning committee arranged the 1 am preview I still don't know.

The planning committee also put together a great selection of social activities and excursions. What conference would be complete without golf? Thursday afternoon the golfers enjoyed a round at close-by Coronado Golf Course. The afternoon sailing on an actual America's Cup Racing Yacht on San Diego Bay was a big hit; I saw quite a few sun-burned faces and photos in the Conference App activity feed. Perhaps the most fun was had by the group touring (and sampling!) three of the best West Coast breweries.

The Annual Banquet again recognized the Zolfo Cooper award winners for the highest scores on the CIRA exam (see p. 17). The highlight of the entire week for me was when I had the honor and privilege of recognizing Valda and Grant Newton for over three decades of service to AIRA. I think they were truly surprised by receiving this year's Manny Katten award.

In place of our traditional Friday night baseball game we enjoyed a guided tour of the world-famous San Diego Zoo, followed by cocktails and dinner. There were many photos posted on the Conference App of the tigers, lions, jaguar, koalas, elephants and other animals we got close to. The zoo was extraordinarily hospitable providing a festive patio with strolling buffet within sight of the elephants.

I am still recovering from a fun, successful, but exhausting week in San Diego and we are already beginning to plan for next year at the Four Seasons resort in Las Colinas (Dallas) Texas. My excitement is starting to overtake my exhaustion. I already look forward to seeing everyone there.

Grant Newton Receives Lifetime Achievement Award from Emory Bankruptcy Developments Journal

ANGELA SHORTALL, CIRA
AIRA President
Protiviti, Inc.

Each year, Emory Bankruptcy Developments Journal (EBDJ) honors a member of the bankruptcy field with the Distinguished Service Award for Lifetime Achievement. This year's recipient was Grant W. Newton, PhD., CIRA, former AIRA Executive Director and Professor Emeritus of Accounting at Pepperdine University.

EDBJ's annual reception and awards banquet took place April 7, at Maggiano's Buckhead restaurant in Atlanta. The award was presented to Grant by Keith Shapiro, founding supporter and advisor of Emory Bankruptcy Developments Journal – also a longtime member and Special Counsel of AIRA. I was pleased to be in attendance at the ceremony along with AIRA Executive Director, Tom Morrow; current and past Board members Stephen Darr, S. Gregory Hays, James Lukenda, and Grant Stein (accompanied by his wife, Janet Stein); Professor Jack Williams; and Valda Newton.

Recently retired from his role as AIRA Executive Director, Grant Newton taught accounting and finance courses for over 20 years in Pepperdine's MBA, Key Executive and Seaver undergraduate programs, as well as teaching at Calif. State University LA, University of Bridgeport, and University of North Alabama. Among other

Pictured Left to Right, Grant Newton and Keith Shapiro.

accomplishments, Grant served on the AICPA Task Force on Financial Reporting by Entities in Reorganization under the Bankruptcy Code, which resulted in the issuance of Statement of Position 90-7. He has advised and served as expert witness on issues dealing with financial reporting during and on emergence from chapter 11, valuation, terms of plan, tax impact of plan, tax issues related to the bankruptcy estate and recovery of assets, among others. Grant has published numerous books and articles including *Bankruptcy and Insolvency Accounting* and *Bankruptcy Taxation* (both published by John Wiley). He received his Ph.D. from New York University, Master's from the University of Alabama, and B.S. from University of North Alabama, from which he received the Alumnus of the Year Award in 1992. For more information about Grant's accomplishments, especially related to his work with AIRA, see p. 16.

Pictured Left to Right, James Lukenda, Grant Newton, Valda Newton , S. Gregory Hays, Angela Shortall and Jack Williams.

Baker Botts v. ASARCO: Equal Opportunity Application of Supreme Court's Prohibition on Fee Defense Reimbursement to All Bankruptcy Professionals

DAVID L. BURY, JR.
Stone & Baxter, LLP[1]

Imagine that you served as debtor's counsel in one of the most successful chapter 11 bankruptcies in history. As a result of your efforts, you obtained a $7+ billion judgment (likely the largest actual damages award ever) which fueled a 100%, $3.56 billion payout to creditors. Inexplicably, your client later objects to your application for $144 million in fees (less than 2% of the judgment). However, after 5 months of litigation, 2,440 hours of review, 6 million pages of discovery, and $8 million in "fee-defense" costs, the bankruptcy court overrules all of your client's objections. Are you entitled to be reimbursed for your fee-defense costs? After *Baker Botts*, the answer is "No."

Specifically, on June 15, 2015, a 6-3 Supreme Court held in *Baker Botts, L.L.P. v. ASARCO, LLC* ("*Baker Botts*") that bankruptcy professionals may not be reimbursed out of the bankruptcy estate for fee-defense costs.[2] Although much has been written about *Baker Botts*' impact on bankruptcy attorneys, little has been written about its impact on other bankruptcy professionals (e.g., accountants, financial advisors, investment bankers). Therefore, this article will summarize (i) what all bankruptcy professionals need to know about *Baker Botts*; (ii) evolution of *Baker Botts* in the lower courts; and (iii) a pending appeal regarding *Baker Botts*' applicability to non-attorney bankruptcy professionals.

Background

In 2005, ASARCO, one of the leading copper producers in the U.S., filed a free-fall chapter 11 (in other words, a traditional, stand-alone chapter 11 restructuring) in the Southern District of Texas. ASARCO had everything wrong with it: cash flow issues; potentially massive environmental liabilities; corporate governance and tax problems; a striking workforce; and a litigious parent company.[3] Acting through its court-appointed, independent board, ASARCO retained two law firms, including Baker Botts, as its bankruptcy counsel.[4]

Baker Botts litigated a fraudulent transfer claim against ASARCO's parents. As a result, ASARCO obtained a $7+

1 The views expressed in this article do not necessarily reflect the views of the author's firm or clients.
2 135 S. Ct. 2158 (2015).
3 *Baker Botts*, 135 S. Ct. at 2163.
4 *Id.*

billion judgment against them.[5] The judgment funded a 100%, $3.56 billion creditor payout. In 2009, ASARCO emerged from bankruptcy "with $1.4 billion in cash, little debt, and resolution of its environmental liabilities."[6] After confirmation, Baker Botts and the other firm filed final fee applications requesting $120 million in fees and a fee enhancement for the successful outcome.[7]

However, back under the control of its parent, ASARCO objected to the fee applications.[8] Following extensive discovery, a 6-day trial, and $8 million in fee-defense costs by Baker Botts, the Bankruptcy Court overruled substantially all of ASARCO's objections. It awarded $120 million in compensation, a $4.1 million enhancement, and $5 million in fee-defense costs. ASARCO appealed.[9]

Supreme Court's Majority Opinion

Following an affirmance by the District Court and a reversal by the Fifth Circuit, the Supreme Court granted certiorari.[10] The majority held that professionals employed under § 327(a) are not entitled under § 330(a)(1) to recover fee-defense costs incurred in "defending" their fee applications. First, absent express statutory or contractual language, the "American Rule" dictates that each litigant pays its own attorneys' fees.[11] Second, § 327(a) and § 330(a): 1) do not expressly shift the burden of fee-defense litigation to the bankruptcy trustee, and 2) only provide for reasonable compensation for actual, necessary services rendered to a bankruptcy trustee in a loyal and disinterested manner.[12] Thus, Congress did not intend to depart from the American Rule with respect to bankruptcy fee-defense costs.

Baker Botts' prohibition on fee-defense reimbursement relies on the majority's construction of §§ 327(a) and 330. Section 327 provides for the employment of "disinterested" professionals "to represent or assist the trustee in carrying out the trustee's duties." The "professionals are hired to serve the administrator of the estate for the benefit of the estate."[13] Section 330(a)(1) permits "reasonable compensation for actual, necessary services rendered."[14] If, as the majority assumes, "services" refers to "labor performed for another," then "litigating a fee application against the administrator of a bankruptcy estate cannot be fairly described" as "labor performed" for, much less "disinterested service" to, that administrator.[15] Therefore, fee defense is not a compensable "service" under § 330(a)(1). Per the Court, if Congress had wanted to shift fee-defense costs, then it "easily could have done so."[16]

5 *Id.*
6 *Id.*
7 *Id.*
8 *Id.*
9 *Id.*
10 *Id.*
11 *Id.* at 2164.
12 *Id.* at 2164-66.
13 *Id.* at 2164.
14 *Id.* at 2164-65.
15 *Id.* at 2165.
16 *Id.* at 2166.

Supreme Court's Dissenting Opinion

The dissent concluded that fee defense might not be a "service" under § 330(a)(1), but it is part of the compensation for the "underlying services."[17] Therefore, it is essential that a bankruptcy court retain its "broad discretion" to determine "reasonable compensation" based on all "relevant factors" (including the possible need to award defense costs to maintain compensation parity between bankruptcy and non-bankruptcy professionals).[18] For the dissent, that need is no different than other factors warranting "increased compensation" (e.g., "exceptionally protracted litigation"). Therefore, additional compensation may be warranted.[19] The dissent concluded that interpreting "reasonable compensation" any other way "would undercut a basic objective of the statute."[20]

What is Compensable after *Baker Botts*?

Regardless of how one views *Baker Botts*, it is now the law of the land. Therefore, it is useful to take stock of what is compensable and what is not compensable after *Baker Botts*.

Employment Applications; Compensation Procedures

To be sure, *Baker Botts* does not suggest that preparing and/or defending an application to employ or a motion to establish compensation procedures is no longer compensable. One is a threshold requirement for employment; the other benefits a host of constituencies, not just the movant. Therefore, they reflect "necessary" services.

Fee Statements; Fee Applications

The cost to prepare, serve, and/or file fee statements and applications is likely recoverable under § 330(a)(6), which deals with "preparation of a fee application."[21] However, post-filing costs associated with objections, corrections, explanations, negotiations, and research are likely not recoverable after *Baker Botts*.

Compensation Hearings

The cost to prepare for, travel to, and/or participate in any contested fee hearing is not recoverable. However, *Baker Botts* is less clear about uncontested hearings. On the one hand, the Court emphasizes *adversarial* litigation as opposed to uncontested but court-ordered hearings.[22] On the other hand, it stated that "work performed in defending a fee application in court" is not compensable. Thus, there is not a solid basis for treating uncontested hearings differently.

17 *Id.* at 2169.
18 *Id.* at 2169-70.
19 *Id.* at 2170.
20 *Id.*
21 11 U.S.C. § 330(a)(6).
22 For example, the Court emphasizes that a court cannot "shift the costs of adversarial litigation from one side to the other," *Baker Botts*, 135 S. Ct. at 2165; that time "spent litigating a fee application against the administrator" is not "disinterested service to" the administrator, *Id.*; that the term "services" does not "encompass adversarial fee defense litigation," *Id.* at 2166; and that parties can "battle" over a fee invoice, *Id.* at 2167.

Continued from p.7

Arguing about *Baker Botts*

With the Court's emphasis on the benefit to the estate, professionals will likely also bear the expense of challenging and testing *Baker Botts*.

Delaware Grapples with *Baker Botts*

Fighting an uphill battle against *Baker Botts* at their own expense is exactly what the big firms are doing in Delaware. Specifically, Andrew Vera, the Acting U.S. Trustee in Delaware, has raised *Baker Botts* in at least five Delaware chapter 11 bankruptcies, including (i) *In re Boomerang Tube, LLC*; (ii) *In re New Gulf Resources, LLC*; and (iii) *Samson Resources Corporation*.[23]

In re Boomerang Tube, LLC

Judge Walrath weighed in on January 29, 2016, to consider a retention provision proposing that, subject to §§ 330 and 331, counsel for a creditors' committee be indemnified for fee-defense costs.[24] In an attempt to get around *Baker Botts* (which dealt with § 327), the applicant proposed the retention under § 328(a). However, Judge Walrath rejected the attempt.

First, Judge Walrath concluded that, like § 330(a), § 328(a) does not explicitly authorize fee shifting and, thus, does not depart from the American Rule.[25] Second, she viewed the retention agreement as an indemnification agreement between the committee and its proposed counsel only; therefore, the committee and its lawyers could not bind the estate.[26] Third, and most convincingly, Judge Walrath concluded that the agreement remained subject to the Code. After *Baker Botts*, fee defense is not a compensable service; therefore, the proposed provision failed § 328(a)'s "reasonable terms" requirement.[27] In other words, Judge Walrath predicted the Supreme Court would have viewed § 328(a) like it viewed § 327. Finally, she concluded that it makes no difference if one views fee defense as an "expense" rather than a "fee."[28]

23 Delaware Bankruptcy Case Nos. 15-11247, 15-12566, and 15-11934, respectively.
24 15-11247 at Dkt. 860.
25 *Id*. at 5.
26 *Id*. at 11.
27 *Id*. at 8; 13.
28 *Id*. at 21.

In re New Gulf Resources, LLC

Judge Shannon adopted Judge Walrath's opinion on February 1, 2016.[29] In *New Gulf*, the debtors moved to employ Baker Botts as counsel under § 327(a).[30] Unlike the *Boomerang Tube* application, the *New Gulf* application is rather exotic. Pointing out that it was charging hourly rates that were 10-15% lower than usual, Baker Botts proposed that it be paid a "Fee Premium" to account for bankruptcy payment risk equal to 10% of its billings during the case, with two conditions: (i) the fee would accrue during the case, but not be payable until the court approved the final fee application, and (ii) the court must determine that Baker Botts incurred "material" fee-defense costs. However, if the court determined that Baker Botts incurred material fee-defense costs, then Baker Botts would earn the Fee Premium "regardless of the outcome of the objection."[31]

Judge Shannon's February 1 opinion letter suggested that he was inclined to reject the Fee Premium. However, he permitted Baker Botts to file another brief on March 2, 2016. In its brief, Baker Botts insisted that it was not seeking compensation for fee defense. Rather, it was merely seeking a payment risk premium.[32] Although it suggested that the premium merely brought its hourly rates in line with the market,[33] there is no getting around the fact that Baker Botts conditioned the premium on the incurrence of material fee-defense costs. As the U.S. Trustee put it, the premium is a "direct attack on *ASARCO*, repackaged."[34] On March 17, Judge Shannon entered a follow-up letter, explaining that "I stand by my earlier determination" that Baker Botts' proposal "runs afoul of the holdings in *Asarco* and *Boomerang Tube*."[35] It was a "creative approach," but there was no "meaningful distinction" between the *New Gulf* and *Boomerang*.[36]

Samson Resources Corporation

On February 8, 2016, Judge Sontchi also adopted Judge Walrath's opinion.[37] Like the *Boomerang Tube* application, the *Samson* application proposed fee-defense

29 15-12566 at Dkt. 228 at 1.
30 15-12566 at Dkt. 54 at ¶3.
31 *Id*. at ¶¶10-13.
32 15-12566 at Dkt. 344 at 3.
33 *Id*. at 5.
34 15-12566 at Dkt. 116 at 6.
35 15-12566 at Dkt. 395 at 1.
36 *Id*.
37 15-11934 at Dkt. 641.

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reimbursement under § 328(a). Judge Sontchi agreed that the Supreme Court would have viewed § 328(a) just like it viewed § 327(a) – neither departs from the American Rule.[38]

Applying *Baker Botts* to Non-Attorney Professionals

Whereas Delaware is considering *Baker Botts* in the attorney context, an Illinois Bankruptcy Court considered *Baker Botts* in the non-attorney context. In *In re River Road Hotel Partners, LLC*, Judge Baer held that *Baker Botts* applied to a financial advisor's fee-defense costs even though the advisor characterized its fee-defense costs as "expenses" under § 330(a)(1)(B) rather than "fees" under § 330(a)(1)(A).[39] That is, the prohibition on fee-defense reimbursement applies equally to attorneys who defend their own applications and to non-attorneys who must pay attorneys for fee defense.

If you are familiar with *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, one of the late Justice Antonin Scalia's last bankruptcy opinions,[40] then you might remember that River Road and its affiliates filed a plan proposing to auction their assets. Amalgamated Bank objected because the plan prohibited credit bids. The Supreme Court rejected the plan for prohibiting credit bidding.[41] The Bankruptcy Court then confirmed Amalgamated's competing plan. The result: a "success fee" dispute.

Specifically, the debtors' financial advisor, FBR Capital Markets & Co., filed a final fee application for $2.5 million in fees, $2.4 million of which amount was a "Restructuring Fee."[42] Amalgamated's post-confirmation entity claimed that FBR had not earned the success fee. After extensive litigation and a remand order from the District Court, the Bankruptcy Court ruled that FBR was entitled to the Restructuring Fee.[43] In FBR's amended fee application, FBR sought a $2.5 million Restructuring Fee and an additional $1.77 million for fee-defense costs.[44] Although the Bankruptcy Court approved the Restructuring Fee, it denied the fee-defense request pursuant to *Baker Botts*.[45]

The Bankruptcy Court Focused on Three Things

First, the retention order provided that expenses were subject to review under § 330. After *Baker Botts*, § 330(a)(1) does not permit fee-defense reimbursement. Second, the Court concluded that there is "no distinction between fees incurred by debtor's counsel and those incurred by a third party's counsel."[46] Third, the Court rejected FBR's contract argument because (i) the fee-defense work arose in litigation against, and did not benefit, the bankruptcy estate and (ii) the indemnification clause did not overcome the American Rule.[47]

Parties Cross-Appealed to the District Court[48]

On February 17, 2016, the United States filed an amicus brief that mirrors its position in Delaware, as follows.[49] First, like § 330(a)(1)(A), § 330(a)(1)(B) does not depart from the American Rule. Second, it rejects FBR's argument that *Baker Botts* applies to attorney professionals only, because § 330(a)(1) applies to *any* "professional person employed under section 327 or 1103."[50] *See also Baker Botts* at 2164 (referring to "compensation for fee-defense litigation by *professionals*" rather than just attorneys) (emphasis added). Finally, it relies on *Boomerang Tube* to reject FBR's "contract argument" (i.e., even if the engagement letter is a contract, the American Rule cannot be altered by a contract that is inconsistent with the Bankruptcy Code).

Conclusion

Some have questioned the Supreme Court's insistence on forcing the American Rule on the Bankruptcy Code. Others have suggested that the Supreme Court failed to read § 330 as a whole and, thus, articulated an overly-narrow definition of "services" that is inconsistent with the Code.

Nevertheless, *Baker Botts* is binding. Therefore, rather than challenging *Baker Botts* head-on, professionals are attempting to evade its reach. To that end, lawyers in Delaware have (i) filed retention motions under § 328 rather than § 327; (ii) added fee-defense provisions to their engagement letters as a contractual workaround; and (iii) even concocted exotic "fee premiums" to defray otherwise non-compensable fee-defense costs. However, three Delaware judges have rejected those challenges.

Similarly, one financial advisor attempted recently to avoid *Baker Botts*' by (i) challenging whether *Baker Botts* even applies to non-attorney professionals; (ii) raising the contract exception to the American Rule; and (iii) characterizing its request for fee-defense reimbursement as an "expense" rather than a "fee." Those arguments failed in the Bankruptcy Court and are now on appeal in the District Court. However, it is difficult to imagine that the District Court will reverse in the financial advisor's favor. The bottom line for now: All bankruptcy professionals are on their own with fee-defense costs.

38 *Id*. at 2.
39 536 B.R. 228, 239-42 (Bankr. N.D. Ill. Aug. 31, 2015).
40 *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 132 S. Ct. 2065 (2012).
41 *Id*. at 2073.
42 *River Road*, 536 at 230-31.
43 *Id*. at 231.
44 *Id*.
45 *Id*.
46 *Id*. at 241.
47 *Id*. at 239-42.
48 *See Bletchley Hotel at O'Hare Field LLC v. FBR Capital Mkts.*, 1:15-cv-08063 (N.D. Ill. Sep. 11, 2015).
49 *See, generally*, *Id*. at Dkt. 29.
50 11 U.S.C. § 330(a)(1).

Leveraged Lending Guidelines, New Debt Structures and Pitfalls in Bankruptcy

LAURA APPLEBY, LARRY G. HALPERIN, NICHOLAS WHITNEY AND SIMONE TATSCH
Chapman and Cutler LLP

Introduction

In today's regulatory regime, traditional banks have become limited in their ability to provide certain leveraged loans under lending guidelines jointly enforced by the Federal Reserve System (the "*Federal Reserve*"), the Office of the Comptroller of the Currency ("*OCC*") and the Federal Deposit Insurance Corporation ("*FDIC*", and together with the Federal Reserve and OCC, the "*Agencies*"). Although certain exceptions to these guidelines exist, the guidelines have resulted in limiting the ability of traditional banks to make loans deemed "risky" by federal regulators.

As a result of these new lending guidelines and the limitations placed on traditional banks, highly levered companies are being forced to turn to non-traditional financing sources. Such sources include non-bank lenders, such as hedge funds and business development companies or "*BDCs*". In addition, the debt facilities provided by these alternative lenders to highly levered companies may be non-traditional, such as unitranche loan facilities. These alternative sources of financing, however, come with increased or different risks, especially when an over-levered company opts to restructure or sell itself as a part of a bankruptcy proceeding.

This article will discuss the leveraged lending guidelines, unitranche facilities and the risks associated with unitranche facilities, including with respect to "agreements among lenders" as illustrated by the recent case of *In re Radio Shack Corporation* ("*RadioShack*").[1]

Leveraged Lending Guidelines

Origin and Goals

On March 22, 2013, the Agencies together issued new guidance for agency-supervised institutions or "traditional lenders" to address concerns relating to an increase in the leveraged lending volumes since 2009 (the "*Leveraged Lending Guidelines*" or the "*Guidelines*").[2] As summarized by the Agencies in the Leveraged Lending Guidelines, the guidance "outlines for agency-supervised institutions high-level principles related to safe-and-sound leveraged lending

1 No. 15-10197 (Bankr. D. Del.). Another case, *In re American Roads LLC,* 496 B.R. 727 (Bankr. S.D.N.Y. 2013), considered an "insured unitranche" facility, which presented issues that are different than those presented with a unitranche facility associated with a financing and involving an agreement among lenders.

2 *See* Interagency Guidance on Leveraged Lending, 78 Fed. Reg. 17766-01 (March 22, 2013), available at https://www.gpo.gov/fdsys/pkg/FR-2013-03-22/pdf/2013-06567.pdf.

activities, including underwriting considerations, assessing and documenting enterprise value, risk management expectations for credit awaiting distribution, stress-testing expectations, pipeline portfolio management, and risk management expectations for exposures held by the institution."[3] These Guidelines superseded previous guidelines issued by the Agencies in April 2001. As a part of the Guidelines, the Agencies highlighted the deterioration of prudent underwriting practices, including the fact that a number of debt facilities no longer contained early warning features such as maintenance covenants. Although the Leveraged Lending Guidelines are not formal rulemaking, traditional lenders who do not comply with the Guidelines could subject themselves to a broad range of potential informal and formal enforcement measures.

Main Restrictions and Exceptions

The Leveraged Lending Guidelines require that each financial institution's credit policies and procedures for leveraged lending address several areas including (i) pipeline limits and hold levels, (ii) appropriate oversight by senior management, along with adequate and timely reporting to the institution's board of directors and (iii) effective underwriting practices for primary loan origination and secondary loan acquisition.

Additionally, with respect to the underwriting standards, the Guidelines provide that financial institutions should analyze whether the borrower has capacity to repay a loan facility and de-lever a sustainable level of the debt over a reasonable period. As a general guide, the Guidelines include provisions suggesting that each financial institution consider whether base case cash flow projections demonstrate the ability of a borrower to fully amortize senior secured debt or repay a significant portion of total debt over the medium term. The Guidelines also assert that in most industries, debt serviced from operating cash flow in excess of 6x total debt/EBITDA raises such concerns. In addition, when identifying possible definitions for the term "levered lending" to be included in the policies of financial institutions, the Guidelines comprise a potential combination of several elements including an even lower leveraged threshold — total debt to EBITDA or senior debt to EBITDA exceeding 4.0x or 3.0x, respectively, and clarify that cash should not be netted against debt (commonly referred to as "Net Leverage Ratios") for purposes of the calculations.

Although the Leveraged Lending Guidelines are seemingly broad in their application, some exceptions do apply. For instance, the Guidelines do not cover bonds (including high-yield bonds). Additionally, traditional asset-based loans ("*ABL*") are generally excluded from the Leveraged Lending Guidelines, although any ABL that is part of a leveraged borrower's overall debt structure may be subject to the Guidelines. Another important exception to the Leveraged Lending Guidelines is the "fallen angel exception." Pursuant to this exception, a financial institution is only required to classify a loan as a "leveraged loan" in four events – when it is (i) originated, (ii) modified, (iii) extended or (iv) refinanced. As a result, if a loan becomes over-leveraged – a "fallen angel" – after these events, it will not be covered by the definition of "leveraged loan." It is important to note, however, that if a levered loan is modified or otherwise amended (such as to address the deterioration in a borrower's credit quality), the Leveraged Lending Guidelines would then apply.

In November 2014, the Agencies issued answers to frequently asked questions with respect to the Guidelines (the "*Additional Guidance*").[4] Pursuant to the Additional Guidance, the Agencies clarified that investments by financial institutions related to collateralized loan obligations ("*CLO*") should be treated as follows: (a) the Guidelines apply when a financial institution markets its loans through a BDC or funds a CLO through a warehouse line and the CLO markets the institution's own loans; (b) the Guidelines do not apply when a financial institution has indirect exposures arising from investments (*i.e.*, in CLOs) and (c) the Guidelines apply if the financial institution funds a BDC or a CLO that holds leveraged loans.

Effect

As will be discussed next, due to the broad restrictions of the Leveraged Lending Guidelines, these Guidelines have acted as a catalyst to foster the development of non-traditional lenders due to concerns of traditional lenders regulated by one of the Agencies that they may run afoul of the Guidelines.

Non-Traditional Financing Sources and Structures — Unitranche Facilities

The restrictions imposed on traditional banks have resulted in non-traditional lenders such as hedge funds and BDCs stepping in to provide companies with over-levered facilities. In doing so, a new market has emerged willing to test new financing structures, such as unitranche loans, the interpretation of which are untested in a bankruptcy proceeding.

A unitranche facility combines what would otherwise be separate first and second lien facilities into a single secured loan facility provided by the same group of lenders and documented through a single credit agreement with one set of collateral documents. The facility may include both a term loan and a revolving loan component. A unitranche facility differs from any other loan facility because rather than a traditional intercreditor agreement to which the borrower is a party, all of the lenders typically enter into an agreement among lenders (the *"Agreement Among Lenders"* or the *"AAL"*) instead.

The primary advantage of the unitranche facility for a borrower is to close the loan facility quickly under a single set of loan documents while maintaining intercreditor arrangements between the first-out lenders and the last-out lenders. These arrangements are made through an Agreement Among Lenders. The AAL divides a single loan into two tranches usually defined as "first-out" and "last-out". The AAL also addresses certain issues

3 *Id.* at p. 17766.

4 *See* Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation and Office of the Comptroller of the Currency, *Frequently Asked Questions (FAQ) for Implementing March 2013 Interagency Guidance on Leveraged Lending* (Nov. 7, 2014), available at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20141107a3.pdf

Continued from p.11

among the lenders such as priority of payments, voting arrangements, buy-out rights, remedy standstill provision, assignments and bankruptcy treatment. Simply put, the loan documents governing the unitranche facility provide for a single lien on the borrower's assets, which is granted to one agent, with the priority of payments addressed in the AAL.

Unitranche facilities are almost always used by lenders in connection with financing provided to middle-market companies. Middle-market companies are generally known in the market to cover companies with $5 million of revenue on the low end, and up to $500 million on the high end. These facilities are most often provided by a smaller "club" of lenders and are typically not available for use in largely syndicated loan facilities. Since each lender in the unitranche facility is required to become party to the AAL, the use of the unitranche facility is better suited for a middle-market club deal as it would be too burdensome to have all of the lenders in a broadly traded syndicated loan facility to enter into an AAL.

Bankruptcy and the Unitranche Facility

Bankruptcy cases with respect to alternative sources of financing such as unitranche facilities are still incipient; therefore such alternatives do not come without risk. While every bankruptcy proceeding is different, the points discussed below provide a snapshot of issues that have recently arisen for secured creditors in bankruptcy proceedings.

Intercreditor Issues

The U.S. Bankruptcy Code and the bankruptcy courts have long recognized the jurisdiction of the bankruptcy courts to entertain intercreditor disputes surrounding subordination agreements. Specifically, section 510 of the Bankruptcy Code provides that a subordination agreement is enforceable in a bankruptcy proceeding to the same extent as under state law.[5] Indeed, the bankruptcy courts have long recognized their jurisdiction to hear disputes regarding subordination agreements where "the equitable reordering of the debtor-creditor and creditor-creditor relations cannot be accomplished in [the] case without resolution of the intercreditor dispute."[6] It is commonplace for bankruptcy courts to hear disputes involving issues of subordination arising under intercreditor agreements executed as part of a traditional financing facility.[7]

The Bankruptcy Code, however, has not caught up with modern alternative sources of financing and this has created uncertainty within the courts. Such lack of clarity is most evident with unitranche facilities. As discussed, unitranche facilities often include a separate Agreement Among Lenders to which the borrower is not a party that governs the relative agreed-to priorities among the lenders. In such facilities, because the borrower typically is not a party, it has remained unclear whether a bankruptcy court would entertain an intercreditor dispute between the first-out and last-out lenders under an AAL.

A recent bankruptcy case that considered issues arising from an Agreement Among Lenders related to a unitranche facility is *RadioShack*.[8] Although the *RadioShack* proceeding sheds light on how bankruptcy courts may interpret an AAL, unfortunately, it still remains unclear as to whether U.S. bankruptcy courts will assert jurisdiction to consider arguments arising under an AAL. In *RadioShack*, all of the relevant parties in the case had consented to the bankruptcy court's jurisdiction to consider the AAL in the underlying dispute, thus allowing the court to disregard the baseline issue of whether or not the court's jurisdiction over the AAL existed.

In re Radio Shack Corporation

In *Radio Shack*, in December 2013, RadioShack as part of a turnaround plan had entered into a $585 million asset-backed credit facility (the *"ABL Facility"*).[9] This ABL Facility was acquired by affiliates of Standard General, L.P. (*"Standard General"*) in October 2014 and the existing debt was reallocated to a $275 million term-out revolving loan facility, a $50 million term loan facility, a $120 million letter of credit facility, and a $140 million revolving facility. Standard General then assigned the $275 million term-out revolving loan facility and the $50 million term loan facility to a group of lenders (the *"First-Out Lenders"*). As part of the transaction, the First-Out Lenders and Standard General, as last-out lender, entered into an AAL. The AAL set forth the respective intercreditor rights of Standard General and the First-Out Lenders, including certain rights of the parties in the event of a bankruptcy proceeding. RadioShack was not a party to the AAL.

Pursuant to the AAL, the obligations owed to the First-Out Lenders were senior to the obligations owed to Standard General, as the last-out lender. The obligations owed to the First-Out Lenders included the loans held by the First-Out Lenders and all fees, costs, expenses, other charges and indemnification obligations incurred by the First-Out Lenders. Importantly, the underlying ABL Facility, and the DIP Credit Agreement to which the First-Out Lenders were a party, contained extensive indemnification provisions. Additionally, pursuant to the AAL, Standard General explicitly did not waive its right to credit bid under the U.S. Bankruptcy Code, so long as the credit bid was in an amount sufficient to pay out the First-Out Lenders "in full" in cash.

As a part of the sale process, Standard General submitted a credit bid for the Debtors' assets (the *"Standard General Bid"*) based on its last-out claims and proposed to fully repay the principal and interest owed the First-Out Lenders in cash. The First-Out Lenders recognized that the Standard General Bid was the only realistic option to preserve the debtors as a going concern. The First-Out

5 11 U.S.C. § 510(a) ("A subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable nonbankruptcy law.").

6 *In re Best Products Co., Inc.*, 168 B.R. 35, 68 (Bankr. S.D.N.Y. 1994).

7 *See, e.g., In re Ion Media Networks*, 419 B.R. 585 (Bankr. S.D.N.Y. 2009) (interpreting intercreditor agreement as part of plan confirmation process); *In re MPM Silicones, LLC,* 518 B.R. 740 (Bankr. S.D.N.Y. 2014) (interpreting intercreditor agreement).

8 Case No. 15-10197 (Bankr. D. Del.).

9 The following background is based upon the pleadings filed by the parties in the RadioShack proceeding.

Lenders asserted, however, that the Standard General Bid constituted a breach of the AAL, because the bid did not account for potential indemnification claims made by the First-Out Lenders for actions that could potentially be brought by the unsecured creditors committee and for an adversary action that had been brought by Salus Capital Partners LLP. The First-Out Lenders argued that the failure to cover the potential indemnification claims was not a payment to the First-Out Lenders "in full."

Over the course of a marathon four-day hearing, the Delaware bankruptcy court heard arguments with respect to the fairness of the Standard General Bid and the relative treatment of the First-Out Lenders. Although the bankruptcy court entertained arguments arising under the AAL, it never had the opportunity to determine whether it had jurisdiction to hear those arguments because the parties consented to the court's jurisdiction.[10]

Because it was not required to determine the jurisdictional issues, the court considered the issue in dispute between the First-Out Lenders and Standard General — "whether or not [the AAL could] directly provide for the transfer of assets free and clear of all of [the First-Out Lenders'] liens, claims, encumbrances [including indemnification claims]," given the language of the AAL.[11] The court noted: "to me, it boils down to a question of treatment of a secured creditor. That secured creditor has rights that must be respected under the documents and rights that must be respected under the Code."[12] The court made these statements in an effort to push the First-Out Lenders and Standard General to settle their issues, which eventually occurred, permitting the bankruptcy court to approve the Standard General Bid.[13]

While the bankruptcy court *did* consider the arguments of the First-Out Lenders and Standard General with respect to the AAL and the enforceability of that agreement, it only provided guidance to the parties. The court *did not* issue an opinion with respect to either its jurisdiction to hear arguments with respect to the AAL or the enforceability of that document. Thus, whether or not a bankruptcy court has jurisdiction to hear issues arising under an AAL and to enforce such agreements remains an unresolved issue.

Despite the *RadioShack* proceeding, it remains unclear what a bankruptcy court would do when issues arising under an AAL in a borrower's bankruptcy proceeding are actually litigated. It is unclear whether a bankruptcy court would view issues arising under an agreement among non-debtor entities as "core" to a debtor's bankruptcy proceeding, thus permitting the bankruptcy court to hear the action.[14] While the *RadioShack* case may be a helpful indication of how a bankruptcy court would interpret the provisions of an AAL, whether or not a bankruptcy court actually possesses jurisdiction to hear such claims has been reserved for another day.

Conclusion

The Leveraged Lending Guidelines put pressure on the ability of traditional banks to make loans to over-levered companies. Hedge funds and BDCs have become alternative sources of financing while traditional banks have seen their participation in the levered lending market decrease. With new sources of financing have come new structures, such as unitranche facilities. Although these financing innovations are welcome, their bankruptcy treatment is still incipient and, therefore, such structures are not without risks.

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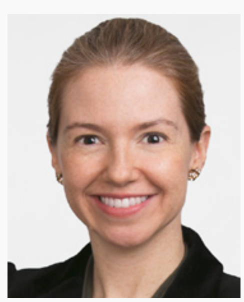

Simone Tatsch

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10 Transcript of Record at 62:23-25, 63:1-3, *In re RadioShack Corp.*, No. 15-10197 (Bankr. D. Del.) (ECF No. 1746). The court provided: "I note, at the outset, that the parties have acknowledged and consented to my jurisdiction to construe and enforce the AAL and other loan documents in these cases."

11 *Id.* at 86:23-25; 87:1.

12 Transcript of Record at 19:12-17, *In re RadioShack Corp.*, No. 15-10197 (Bankr. D. Del.) (ECF No. 1746).

13 The parties ultimately settled on an expense reserve for $5 million and an indemnification reserve of $7 million, while retaining any rights that they may have against each other under the AAL and related documents. On March 31, 2015, as a result of this settlement and the resolution of other objections to the sale process, the bankruptcy court approved Standard General's credit bid.

14 *See, e.g., Stern v. Marshall*, 131 S.Ct. 2594 (2011) (discussing the relatively narrow jurisdiction of the bankruptcy courts in so-called non-core matters).

Second Circuit Upholds Bankruptcy "Safe Harbor" for SecuritiesTransactions

WILLIAM H. SCHRAG AND SHAUN D. MCELHENNY
Thompson Hine LLP

The U.S. Court of Appeals for the Second Circuit recently ruled that constructive fraudulent conveyance claims arising under state law are preempted by the U.S. Bankruptcy Code, 11 U.S.C. § 101 *et seq.* (Code), where the transfers were made by or to financial intermediaries effectuating settlement payments in securities transactions or made in connection with a securities contract, irrespective of whether the plaintiff is a debtor in possession, bankruptcy trustee or other creditors' representative.

The provision at issue, Code § 546(e), states that a trustee may not avoid payments made in connection with securities transactions, with the exception of claims for intentional fraudulent conveyance.[1] In the case of *In re: Tribune Company Fraudulent Conveyance Litigation*,[2] a group of unsecured creditors formed a litigation trust to bring state law-based constructive fraudulent conveyance claims, pursuant to Tribune's confirmed plan of reorganization, seeking to avoid over $8 billion in payments made to Tribune Company shareholders as part of that company's 2007 leveraged buyout. The U.S. District Court for the Southern District of New York denied the former shareholder defendants' motion to dismiss insofar as it relied on the Code § 546(e) safe harbor for securities transactions, holding that the statute, by its plain language, applies only to trustees and not creditors acting on their own behalf. However, the district court granted the motion to dismiss on an unrelated standing issue.

The Second Circuit overruled the district court's decision upon a *de novo* review.[3] After initially reversing on the standing issue, the court held that despite language in Code § 546(e) barring constructive fraudulent conveyance claims by the trustee, the statute's preemptive effect implicitly extends to creditors as well. The court noted that federal law is preeminent in the bankruptcy context, and further that the legislative history of Code § 546(e) and its complete text demonstrate a clear objective to promote stability in securities markets. As such, state law claims such as those asserted by or on behalf of the creditors in *Tribune* would be an obstacle to the legislative purpose of Code § 546(e), and should be precluded. The court also noted that there would be no intrusion into traditional areas of state concern.

The *Tribune* appeal presented the Second Circuit with a matter of first impression at the appellate level, as only two district court decisions had previously ruled on this issue: the lower court in *Tribune*[4] and *In re: Lyondell Chemical Company*,[5] which extensively cited the former decision. The use of state law constructive fraudulent conveyance claims to unwind securities transactions is a relatively novel litigation strategy devised by creditors hoping to find a loophole in the Code that allows a trustee to bring intentional fraudulent conveyance claims but prevents him or her from bringing any other type of claim to avoid securities transactions. The Second Circuit's expansive reading of the safe harbor provision, however, decisively barred the creditors' claims in *Tribune*.[6]

It is important to note that the *Tribune* decision applies only to the Code § 546(e) safe harbor, and does not affect all other types of clawback actions.[7] A trustee or debtor in possession may still bring claims of intentional fraudulent conveyance (which indeed are still pending in *Tribune* and *Lyondell*), and even state law-based claims may still be brought if securities transactions are not at issue. Regardless, the decision will have a substantial limiting impact on pending and future fraudulent conveyance actions, particularly in view of the more stringent pleading standards applicable to claims of intentional fraudulent conveyance.

Fraudulent conveyance claims may have a significant impact on parties to bankruptcy proceedings, entities pursuing business combinations regarding securities contracts and investors of all stripes who may later see their securities sale proceeds become the subject of a litigation claim, regardless of their level of involvement in the transaction. As creditors continue to explore the outer bounds and limits of fraudulent conveyance law, the strategies of litigants and the reactions of regulators and courts will continue to be closely monitored and reviewed.

This article is intended to inform readers about legal matters of current interest. It is not intended as legal advice. Readers should not act upon the information contained in it without professional counsel.

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1 As used in the statute, "trustee" also refers to a debtor in possession.

2 818 F. 3d 98 (2d Cir. 2016). A petition for rehearing or rehearing *en banc* was filed by the plaintiffs on April 12, 2016 but has not been decided yet.

3 In an unusual series of steps, the Second Circuit withdrew a nearly identical opinion entered several days earlier, stating that it had been published in error, only to publish it one day later with relatively minor, non-substantive changes.

4 499 B.R. 310 (S.D.N.Y. 2013).

5 500 B.R. 348 (Bankr. S.D.N.Y. 2014).

6 In a summary order on an accompanying appeal arising out of the *SemGroup* bankruptcy, the Second Circuit also held that, for substantially the same reasons set forth in *Tribune*, constructive fraudulent conveyance claims are preempted by Code § 546(g), which prohibits the avoidance of payments made in connection with swap transactions. *See Whyte v. Barclays Bank*, Docket No. 13-2653 (2d Cir. Mar. 24, 2016).

7 As previously noted, the *Tribune* decision was also the basis for resolving an accompanying appeal in *SemGroup* with respect to the safe harbor provision for swap transactions in Code § 546(g).

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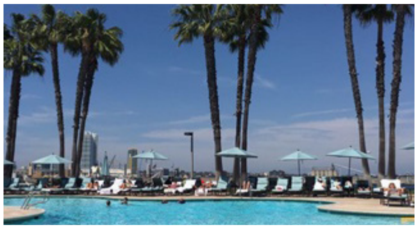




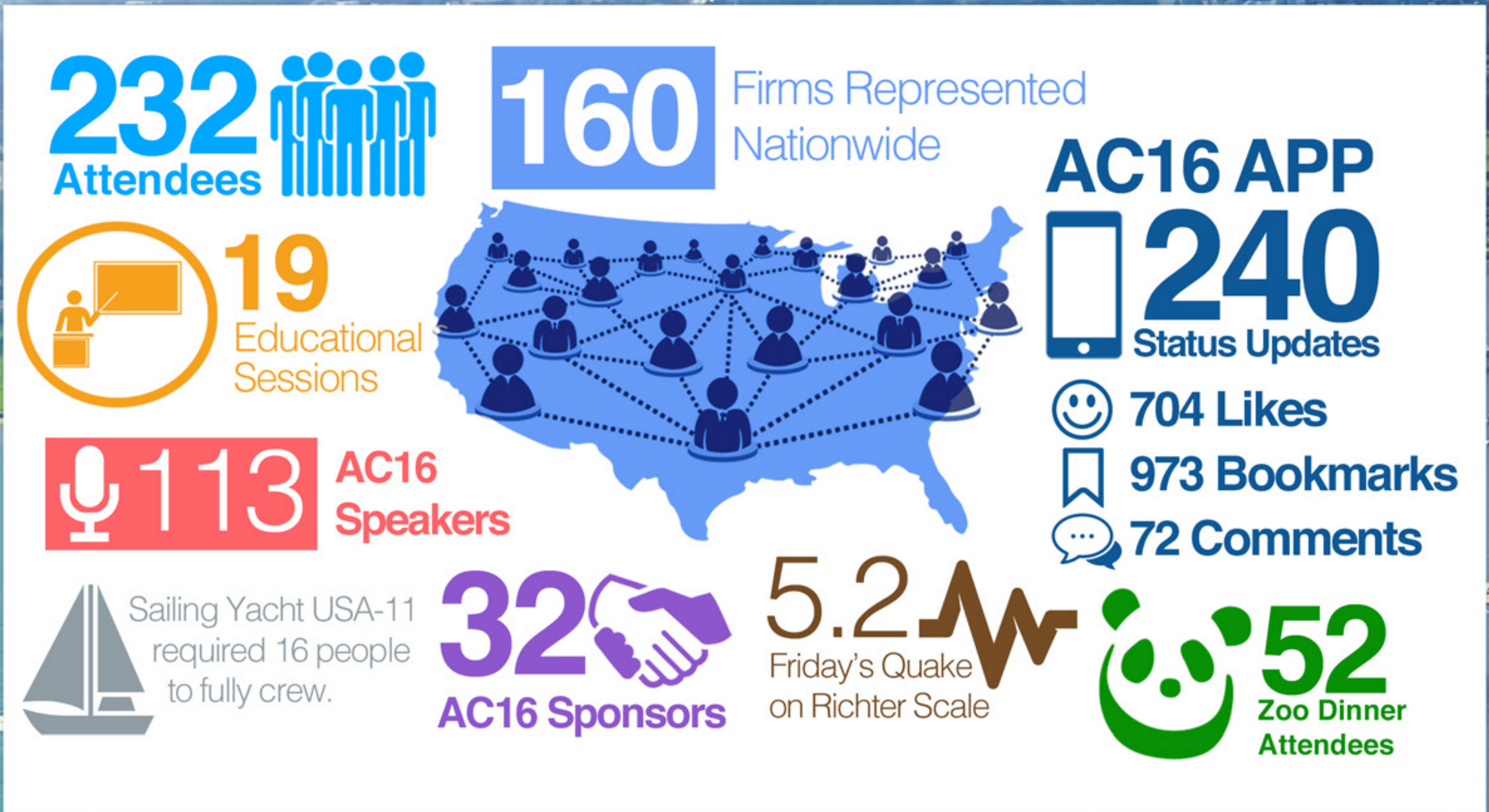








32ND Annual BANKRUPTCY & RESTRUCTURING Conference Hightlights



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Misael Natal Pabon,CIRA

RSM Puerto Rico

Misael is a CPA and Senior Consultant and Business Advisor with RSM Puerto Rico, in San Juan, Puerto Rico. He received a Bachelor's degree in Accounting from the University of Puerto Rico. In addition to the Gold Medal award, Misael received the CIRA certification in March 2016.

SILVER MEDAL

Abhimanyu "Abhi" Gupta, CIRA

Conway MacKenzie Inc.

Abhi is a Director with Conway MacKenzie in New York City. Prior to working for Conway MacKenzie, he was an Associate with Silverman Consulting in Illinois. Abhi graduated from the full time MBA program at NYU Stern in 2009 and was Dr. Edward Altman's research assistant during such time. Abhi received his CIRA certification in October of 2015.

BRONZE MEDAL

Aida Escribano, CIRA

BDO Puerto Rico, P.S.C.

Aida is a Manager with BDO Puerto Rico. Aida graduated from the University of Puerto Rico with a Bachelor's degree and received the CIRA certification in March 2015.

BRONZE MEDAL

Bruce Budge

FTI Consulting

Bruce is a Senior Managing Director with FTI Consulting in Seattle, Washington. He received his Bachelor's degree in Accounting from the University of Idaho.

Certificates of Distinguished Performance

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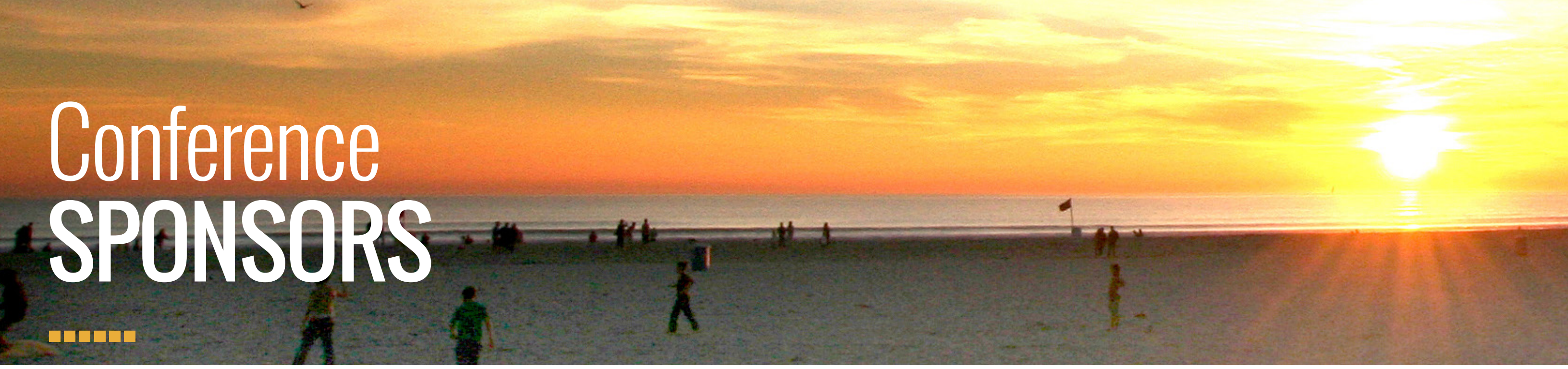

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Bankruptcy Taxes

Tax Treatment of Bankruptcy Related Expenses

PETER ENYART, SECTION EDITOR
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Financially troubled businesses will likely incur legal and professional fees ("transaction expenses") as they proceed through bankruptcy. The deductibility of these transaction expenses for federal income tax purposes depends on the nature of each expense and the facts and circumstances related to the expense. Generally, an amount paid to institute or administer a proceeding under chapter 11 of the Bankruptcy Code[1] is capitalizable, which will defer the tax deductibility of the expense until a subsequent capital transaction (e.g., a liquidation event). This is because the Treasury Regulations treat such costs as a restructuring, recapitalization, or reorganization of the capital structure of a business entity.[2] However, in certain circumstances, a tax deduction may be recognized sooner if the underlying cost is more appropriately classified as something different; such as a business operational expense, a cost of a taxable sale or a borrowing cost.

IRS Ruling Shines Light on Certain Costs

Consider the following example: A U.S. corporate taxpayer ("Taxpayer") voluntarily petitions for relief under chapter 11 with the bankruptcy court, and its debtors file a chapter 11 plan with the bankruptcy court. Here the court approved a plan whereby the Taxpayer would: (i) refinance with creditors pursuant to a debtor-in-possession (DIP) financing facility, (ii) sell its business to a new entity created by the creditors, and (iii) then liquidate. As a result, the Taxpayer's business was now owned by certain creditors and all former shareholders surrendered their stock. The facts from this example are similar to a private letter ruling[3] (the "Ruling") issued by the Internal Revenue Service (IRS). The Ruling provides an analysis of how the IRS may treat certain transaction expenses that a taxpayer would incur in a bankruptcy. Specifically, the Ruling addresses the Taxpayer's ordinary operational expenses, expenses related to the taxable sale of business assets, bankruptcy administrative expenses and debt financing expenses.

Operational Expenses

In the Ruling, the Taxpayer continued to operate its business and generated various operating expenses. The Ruling identified wages, compensation, payments for utilities, and overhead expenses from the Taxpayer's daily business operations as operating expenses. The IRS determined that the Taxpayer's bankruptcy trustee was permitted to deduct its operating expenses as ordinary and necessary business expenses under Internal Revenue Code (IRC) Section 162 in the same manner and to the same extent they would have been if the bankruptcy proceeding had not been instituted. Therefore, it is imperative to distinguish transaction expenses incurred as a result of the bankruptcy from a business' operating expenses.

Expenses Related to Selling Business Assets

Pursuant to the bankruptcy plan, the Taxpayer in the Ruling entered into an asset purchase agreement and sold its assets to a newly-created entity owned by the creditors. The Taxpayer represented in the Ruling that the asset purchase agreement was structured to be a fully taxable asset sale. The Taxpayer incurred costs for negotiating and drafting an asset purchase agreement and for other expenses to facilitate th-e sale of the Taxpayer's assets. The IRS applied the Treasury Regulations, which provide that a taxpayer must capitalize an amount incurred to facilitate an acquisition of assets that constitute a trade or business (whether the taxpayer is the acquirer in or the target of the acquisition).[4] As a result, the Taxpayer was required to treat the costs of the taxable sale of assets as a reduction of the amount realized on the sale of assets. Therefore, these transaction expenses generated either a reduced capital gain or a larger capital loss, depending on the value of the assets being sold.

Additionally, from the Ruling, the Taxpayer represented that the asset purchase agreement was a fully taxable asset sale. However, business sales, including Bankruptcy Code section 363 Sales ("363 Sales"), are not always taxable. It is often advantageous to reorganize a financially troubled corporation in a tax-free IRC section 368(a)(1)(G) reorganization (commonly referred to as a "G Reorganization") to minimize income tax from the sale and to preserve tax attributes when the business emerges from bankruptcy, such as net operating losses (NOLs). Taxpayers may not elect whether the sale will be taxable or nontaxable, even when in bankruptcy. Instead, the tax treatment of the transaction costs will be determined based on the form and substance of the transaction.

1 Unless otherwise noted, all references to Code sections pertain to the Internal Revenue Code (26 U.S.C.).
2 Treas. Reg. §§1.263(a)-5(a)(4), 1.263(a)-5(c)(4).
3 Private Letter Ruling 201138022
4 Treas. Reg. §1.263(a)-5(a)(1).

the liquidation occurred in a later period (or not until some unforeseen future event), the deduction of these costs would be deferred. Again, consider a G Reorganization where the taxpayer survives the reorganization for federal income tax purposes. A Taxpayer that incurs bankruptcy administrative expenses in a G Reorganization would defer the tax deduction of its bankruptcy administrative expenses (and other capitalizable transaction costs) until the Taxpayer is liquidated.

Thus, a taxpayer needs to first determine whether or not a transaction is a taxable transaction before it can properly apply the tax rules with respect to its related transaction expenses.

The capitalization rules would defer the tax deductibility of capitalized transaction expenses incurred in a tax-free sale until a subsequent recognition event (e.g., a liquidation event). These reorganization costs share the same capitalization rules with bankruptcy administrative expenses discussed below.[5]

Bankruptcy Administrative Expenses

An amount paid to institute or administer a proceeding under chapter 11 of the Bankruptcy Code by the taxpayer-debtor constitutes an amount paid to facilitate a reorganization.[6] The Ruling held that the Taxpayer's bankruptcy administrative expenses, including the expenses incurred to negotiate and draft the bankruptcy plan (and other documents required by the bankruptcy proceedings), were therefore capitalizable expenditures. Additionally, these capitalizable expenditures included the Taxpayer's costs to reconcile the creditor's claims and the costs to implement the automatic bankruptcy stay.

The amounts capitalized under these Treasury Regulations[7] are deductible under IRC section 165 if the transaction is ultimately abandoned. Based on the facts from the Ruling, the Taxpayer liquidated pursuant to its bankruptcy plan in the year of the sale. As a result, the Taxpayer was entitled to a loss equal to its capitalized bankruptcy administrative expenses. Alternatively, had

5 Treas. Reg. §1.263(a)-5(a)(4).
6 Treas. Reg. §1.263(a)-5(c)(4).
7 Treas. Reg. §1.263(a)-5 in general.

Debt Financing Costs

In connection with the DIP financing facility, the Taxpayer incurred borrowing costs. The borrowing costs included costs of negotiating the terms of and preparing filings related to the DIP financing facility. On a subsequent date, the DIP financing facility was fully retired. The IRS treated the costs as amounts paid to facilitate a borrowing, which are treated as reducing the issue price, and thereby creating (or increasing) the original issue discount (OID) which gets deducted over the life of the loan. The Ruling shows that the debt financing costs are costs to facilitate a borrowing and should not be treated as capitalizable bankruptcy administrative expenses.

Once the Taxpayer retired the DIP financing facility, any unamortized portion of the capitalized borrowing costs were deductible. However, even if the DIP financing facility had not been retired early, the capitalized borrowing costs would have been deductible over the life of the debt.

Conclusion

Businesses can incur a host of transaction expenses during a bankruptcy proceeding. Some of these costs may be directly related to the bankruptcy proceedings while others may be indirectly related. Understanding the nature of these expenses is critical for proper income tax reporting. Although amounts paid to institute or administer a bankruptcy proceeding are generally capitalizable, a thorough analysis of the costs will likely identify certain transaction expenses that are more appropriately treated as something different, which can lead to more advantageous tax treatment. Some of these other costs could include typical business operation expenses, costs of a sale, and/or a debt financing costs as discussed in the Ruling. And while the Ruling may not be used as precedent, it does provide a valuable analysis which taxpayers can use to determine how various bankruptcy transaction costs should be treated for federal income tax purposes.

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Peter Enyart is a tax manager in RSM's Mergers and Acquisitions Tax Practice. His experience includes serving both publicly-traded (SEC) and closely-held clients on federal, international, and state and local tax matters. Peter focuses on advising clients on the federal tax consequences of mergers, acquisitions and dispositions, including tax structuring and tax modeling, tax due diligence, change in control attribute analysis, transaction cost analysis, bankruptcy tax analysis and structuring, debt restructuring, and stock basis and earnings and profits studies. Recently, Peter completed a rotation with the firm's Washington National Tax office where he delivered advice and consultation regarding complex corporate and partnership tax matters.

Priority of Tax Liabilities in Bankruptcy

JONATHAN BAKER

Balasa Dinverno Foltz LLC

When a company enters bankruptcy, it is likely to owe money to a wide variety of creditors. These creditors often include federal, state and local tax jurisdictions. The effects bankruptcy has on the company's tax liabilities, both past and future, and the ability of the Internal Revenue Service ("IRS") and other tax state and local tax authorities to collect these liabilities is often an important question. Unfortunately, the Internal Revenue Code and the Bankruptcy Code were drafted at different times with different goals, with little thought given to the coordination of the two regimes. As a result, determining the status of tax claims in bankruptcy can be difficult. Since there may be substantial tax liabilities outstanding when a company enters bankruptcy, thought should be given to the priority these tax claims will receive and how to mitigate these liabilities in the context of a bankruptcy restructuring.

History

The status of tax debts in bankruptcy has evolved over time. Before 1966, tax debts were not dischargeable in bankruptcy. From 1966 to 1978, tax debts could be discharged in certain situations and tax claims were generally afforded low priority in the distribution of bankruptcy estates. After 1978, Congress, concerned with the potential for tax avoidance, amended the statute to grant priority status to tax debts incurred within three years of the bankruptcy petition.[1]

Priority of Claims in General

In general, secured creditors (i.e. those with a lien on property of the bankruptcy estate) are entitled to priority in the distribution of property of the estate to the extent of their lien.[2] After that, the Bankruptcy Code provides that certain unsecured claims receive a priority in the distribution of estate assets, in the following order: (1) certain unsecured domestic support obligations, (2) administrative expenses (which include tax obligations incurred during the administration of the bankruptcy estate), (3) certain unsecured claims arising in the ordinary course of business prior to the appointment of a trustee in an involuntary petition, (4) unsecured claims for certain wages, (5) unsecured claims for certain employee benefits, (6) certain unsecured claims of farmers and fishermen, (7) certain unsecured claims of individuals arising from deposits for services not provided, (8) certain unsecured claims of governmental units, including claims for taxes, (9) unsecured claims by debtor to the Federal Deposit Insurance Corporation ("FDIC") or other bank regulatory agencies, (10) certain unsecured claims for death or personal injuries related to a debtor's intoxication.[3] Unsecured claims that do not fall in one of the above priority claims come behind the priority claims in the distribution of estate assets.[4]

1 11 USC §507(a)

2 11 USC §724(b)

Tax Claims Priority

The timing and nature of a tax claim will dictate whether it will have a priority, and whether it can be discharged in bankruptcy.

Tax Liens

Secured creditors have the strongest rights in a bankruptcy proceeding. As a result, debtors often work to avoid liens and reduce these secured creditors to the status of general unsecured creditors. The Internal Revenue Code provides that a tax lien automatically arises in favor of the United States upon all the property of the taxpayer upon assessment.[5,6] However, that lien is not perfected until the IRS properly files a notice of lien.[7]

Once a tax lien has been properly filed and recorded, it generally cannot be avoided. However, often other, sometimes even unsecured, claims receive higher priority than a secured tax claim. For example, in a chapter 7 proceeding, property of the bankruptcy estate subject to a perfected and unavoidable tax lien is distributed in the following order of priority: (1) Liens senior to the tax lien, (2) certain unsecured claims under 11 USC §507(a)(1)-(7) (i.e., administrative expenses, wage claims, etc.), (3) secured tax claims (less amount of unsecured claims entitled to prior payment), (4) liens junior to the tax claim, and (5) the unpaid portion, if any, of secured tax claims.[8] As you can see, even a secured tax claim will be subordinated to certain unsecured claims deemed to have higher priority.

In a chapter 11 proceeding, there is more flexibility. In general, a claim is secured to the extent of the value

3 11 USC §507(a)

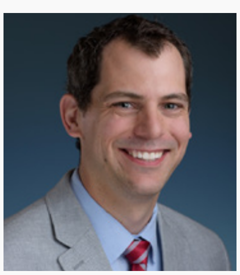
4 11 USC §726

5 Unless otherwise indicated, all "§" references are to the Internal Revenue Code of 1986, as amended (the "Code" or "IRC"), and all "Treas. Reg. §," "Temp. Treas. Reg. §" and "Prop. Treas. Reg. §" references are to the final, temporary and proposed Regulations, respectively, promulgated thereunder (the "Treasury Regulations"), all as in effect as of the date of this memorandum. All "Service" or "IRS" references are to the Internal Revenue Service.

6 §6321

7 §6323(f)

8 11 USC §724(b)(6)



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of its collateral.[9] As a result, valuation is often a point of contention between the parties. Under chapter 11 procedures, a tax claim must be assigned to a class of claims. Under the general rules of chapter 11, a bankruptcy reorganization plan must be approved by each holder in a class of claims if that class of claims receives less than it would in a chapter 7 proceeding.[10] In addition, any class of claims that is not receiving full value for its claims must have the plan approved by creditors holding at least two-thirds in amount and one-half in number of claims for the plan to be approved.[11] Any class of claims that is not impaired is deemed to have consented to the plan. As a result, plans are often structured such that IRS claims are unimpaired, obviating the need for IRS consent to the plan. If planning around this is impossible, there are a few limited options to force IRS acceptance of the plan under the "cramdown" provisions, which can allow the bankruptcy courts to modify loan terms that are subject to certain conditions in an attempt to have the creditors fare better than they would have without such modifications.[12] Otherwise, IRS consent must be received for the plan to be approved.

Unsecured Tax Claims

The priority of unsecured tax claims is largely dependent on when the claim arises. Taxes incurred during the administration of the estate are given second priority along with other administrative expenses.[13] If an involuntary petition was filed, tax claims arising in the ordinary course of business, before either a trustee is appointed or an order for relief is entered, are afforded third priority.[14] Payroll taxes associated with qualifying wage claims will receive fourth priority. It should be noted that second and third priority items (meaning administrative expenses, including taxes incurred during the administration of the estate, and taxes incurred after an involuntary petition is filed in the ordinary course of business) must be paid in cash on the effective date of the plan. Fourth priority claimants must receive deferred cash payments equal to the claim if the class approves the plan, or cash up front if the class does not approve the plan.[15]

Income tax claims stemming from a taxable year ending on or before the filing date of the bankruptcy petition for which either (a) a return is due within three years prior to the filing of the petition, (b) is assessed within 240 days before the petition is filed, or (c) not assessed before, but are still assessable after, commencement of the bankruptcy proceedings are entitled to eighth priority.[16] This priority also extends to certain withholding taxes, property taxes assessed and payable within one year before the petition is filed, certain employment and excise taxes, certain customs duties, and certain penalties.[17]

9 11 USC §506(a)(1)
10 11 USC §1129(a)(7)(A)
11 11 USC §1129(a)(8), 1126(c)
12 11 USC §1129(b)
13 11 USC §507(a)(2)
14 11 USC §507(a)(3)
15 11 USC §1129(a)(9)(A), (B)
16 11 USC 507(a)(8)
17 *Id.*

To the extent unsecured tax claims don't fall into the above discussed priorities, they are treated as general unsecured claims. However, if the IRS is deemed to be a general unsecured debtor, and does not receive full payment in the proposed plan of reorganization, for the plan to be approved the IRS must receive at least as much as it would have received in chapter 7 liquidation and the class as a whole must accept the plan.[18]

Transferee Liability – A Trap for the Unwary

In general, when a company sells its assets, the buyer is not responsible for the tax liabilities of the seller. However, some courts have created the doctrine of successor tax liability that may cause a buyer to be liable for the tax liabilities of the seller's assets in five situations: (1) the purchaser expressly or impliedly agrees to assume the obligation, (2) the transaction is a consolidation or *de facto* merger,[19] (3) the purchasing corporation is merely a continuation of the selling corporation, (4) the transaction is fraudulently entered into to escape liability, and (5) the transfer was made without adequate consideration. This judicial doctrine, which has not gained full acceptance by the courts, nevertheless creates some uncertainty on the status of predecessor liabilities in the context of a bankruptcy sale. As a result, when structuring an asset sale as part of a bankruptcy proceeding, consideration should be given to the potential application of the successor liability doctrine.

Conclusion

As can be seen above, though even secured tax liabilities are subordinate to certain unsecured claims, it is also relatively difficult to have tax liabilities from the three most recent taxable years discharged. As a result, the timing of the filing of the bankruptcy petition can minimize the amount of taxes that receive a priority. Consider, for example, a corporation that files on a calendar year basis and files its return timely, after extension, on September 15th of each year. It has liabilities outstanding for the years ending 2012, 2013, 2014 and 2015. On August 20, 2016 the company is considering filing a bankruptcy petition. If it files on September 1, 2016, the tax liabilities from 2012, 2013, 2014 and 2015 will receive priority status. However, if the petition is not filed until October 1, 2015, the tax liability form the 2012 return will not receive priority status.

In addition, in the context of a chapter 11 plan, the bankruptcy reorganization plan can be structured to minimize the ability of the IRS to hold up the acceptance of the plan, either through ensuring IRS claims are fully funded and thus deemed to accept of the plan, or, in more extreme circumstances, utilizing the "cramdown" provisions.

By giving consideration to the above discussed priorities and rules surrounding tax claims in bankruptcy, a company can help reduce the amount of tax claims receiving priority and give themselves more flexibility in bankruptcy planning.

18 11 USC §1129(a)(7)
19 *Commonwealth of Pa. v. William Lavelle, III & Lavco, Inc.*, 555A.2d 218

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