AIRA | Association of Insolvency & Restructuring Advisors

# Journal

VOL. 31 NO. 2 - 2017


## Receiverships: Types, Powers, Benefits and Drawbacks

*Steven Mitnick and Marc D. Miceli*

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33rd Annual Bankruptcy & Restructuring Conference Section starts on p.14

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# WHAT'S INSIDE






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

# From the Executive Director's Desk

**THOMAS MORROW, CIRA**

*AIRA*

Most of those reading this column are AIRA members because they became involved in the CIRA program. The Certified Insolvency and Restructuring Advisor was the first certification program for financial advisors in the restructuring industry and remains the largest program. Not surprisingly, many of the largest and most successful firms in the restructuring business use the program to train all their new recruits. This allows these firms to get greater value faster from their significant investment in their human capital.

During 2016, we saw 238 students take CIRA classes. At our Annual Conference, we awarded 32 CIRA certificates for successfully completing all three parts and meeting the experience requirements. We currently have 108 people who have taken at least one class and are working their way through the program. Since its inception in 1992 we have awarded 1771 certificates and 951 continue as active practitioners.

This year we continue to have strong support for the program. I believe that firms are hiring new staff to be prepared to meet the demands of a continuing upswing in the restructuring industry. This year, we have seen 68 people take the CIRA 1 course, 39 people take the CIRA 2 course, and 25 take the CIRA 3 course.

If you are not yet a CIRA, I encourage you to get started or to advance your education. We are offering CIRA 1 one more time this year, starting August 8 in Chicago. The CIRA 2 course will be offered twice more, starting August 29 in New York and September 26 in Chicago. Finally, CIRA 3 will be offered once more, starting November 7 in Chicago.

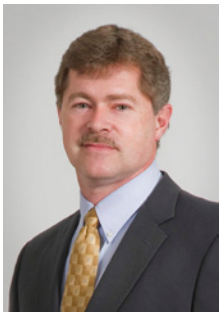
If you have been thinking about becoming a CIRA now is the time to act. The longer you wait the bigger the lead you are giving to your competitors. They are getting trained and finding more work because of it. The CIRA is becoming a required credential for new hires in the business. It increases your effectiveness on client engagements, makes you more valuable to your firm, and leads to promotion more quickly. Most importantly, it allows your firm to get more value for your new-found expertise and opens up more engagement opportunities to apply your new skills. So, what are you waiting for?

# A Letter from **AIRA's Chairwoman**

**ANGELA SHORTALL, CIRA**
*Protiviti Inc.*

I have never had eighteen months pass so quickly! In January 2016, Tom Morrow resigned as President of AIRA to take over the role of Executive Director when Grant Newton retired. At the conclusion of the AIRA's 33rd Annual Conference in Dallas, I completed my term as President and have now officially passed the baton to Joel Waite of Young Conaway Stargatt & Taylor LLP. The last year and a half have been incredibly busy but it has also been a blast; I am so pleased with what the organization was able to accomplish during this time. In particular, I am very proud of the top-quality educational offerings we have made, and continue to make, available to the insolvency community. I had the privilege of serving as co-chair of the 32nd Annual Conference in Philadelphia as President-Elect and then on the committee for the Dallas conference in my role as President. In both instances, the caliber of the professionals on the Committee and the level of commitment to putting together top-notch educational programing was remarkable. I have had the honor of working on many other conferences before and during my eighteen month tenure as President, including those listed below (some are coming up soon). Please make the effort to join us at one, some, or all of these events – you won't be disappointed!

- September 12 – 6th Annual Energy Summit. This one-day program in Dallas focuses on issues facing the Oil and Gas Industry, and is offered in partnership with CFA's Southwest Chapter.
- October 8-11 – National Conference of Bankruptcy Judges. AIRA hosts the opening reception and a breakfast program at the Paris Hotel, Las Vegas.
- November 13 – Advanced Restructuring & POR Conference in New York. Join us for an intensive all-day program and honor a bankruptcy judge (TBA) for his/her service to the industry.
- January 16 – NYIC-AIRA Joint Bankruptcy Event. NYIC is a great organization and we are fortunate to be able to partner with them for this event in its 13th year.
- June 13-16 – AIRA's 34th Annual Conference in Nashville. I mention this especially so you will note the date, as it is a little later than usual. This was necessary to avoid a conflict with the CMA Music Festival June 7-10.



**Joel A. Waite**

I want to thank you, our members, for the opportunity to serve you as President of AIRA. It was truly an honor. I now leave you in the very capable hands of Joel Waite. Please join me in welcoming Joel and offering our continued support to the Officers and Directors of AIRA. Your efforts will yield a great ROI!

# Receiverships: Types, Powers, Benefits and Drawbacks

**STEVEN MITNICK AND MARC D. MICELI**
*SM Law, PC*


With the rising costs associated with federal bankruptcy proceedings, state court alternatives to traditional chapter 11 or chapter 7 bankruptcy cases are increasingly being utilized by seasoned practitioners. One such alternative to a federal bankruptcy is a receivership.

State court receiverships are typically commenced by secured lenders seeking to enforce their liens after a default by the debtor, or by shareholders of businesses or creditors who are seeking to enjoin corporate malfeasance or waste and misappropriation of corporate assets, or by a single creditor seeking to enforce its claim.[1] Thus, a receiver is often appointed during the pendency of a lawsuit, such as a foreclosure or a shareholder dispute. Once the court appoints the receiver, the receiver is empowered to secure the debtor's assets, and in some cases, to shut down the business.

In a state court receivership, the receivership action is commenced by way of an order to show cause, with a verified complaint.[2] Since a receivership action is an equitable remedy, the receivership will often be adjudicated before a chancery court sitting in equity. The order appointing the receiver is typically tailor-made to address the particular circumstances of each case and will usually grant very specific powers to the receiver which are deemed necessary to allow him or her to deal with the issues at hand.

Also, because of the receiver's broad powers and the potentially disruptive effect on a business, an appointment of a receiver is considered a harsh and extraordinary remedy requiring a party to provide substantial evidence which clearly demonstrates the necessity for such an appointment.[3]

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1 *See e.g. Neff v. Progress Bldg. Materials Co.,* 139 N.J. Eq. 356, 358 (Ch. 1947) ("To warrant the dissolution of the company on the ground intimated by the bill, the complainant must charge and adequately establish the three essentially jurisdictional facts: (1) defendant's business has been conducted prejudicially and at great loss; (2) it is being so conducted; and (3) the defendant's business cannot be conducted in the future with safety to the public and advantage to the stockholders") (internal citations omitted).

2 In New Jersey, the procedures governing receivership actions are contained in Court Rule 4:53-1, *et seq*.

3 *See e.g. Neff v. Progress Bldg. Materials Co.*, 139 N.J. Eq. 356, 357 (Ch. 1947) ("The appointment of receivers of corporate organizations, whether to accomplish a liquidation under the authority of the Corporation Act or to serve in a custodial capacity in pursuance of the inherent equitable jurisdiction of this court, is an important adjudication which is rendered only with supreme caution and upon imposing and persuasive supporting proof."). *See also Ravin, Sarasohn, Cook, Baumgarten, Fisch & Rosen, P.C. v. Lowenstein Sandler, P.C.,* 365 N.J. Super. 241 (App. Div. 2003) (stating that "[t]he appointment of any receiver is an extraordinary remedy, and involves the delicate exercise of judicial discretion. It has been said that appointment of a receiver where corporate assets are involved may proceed only upon imposing and persuasive proof. This requirement stems in part from 'paralytic' effect of a receiver on the corporation.") (internal citations omitted).

There are different types of receivers, whose powers can be extensive or quite limited. While the rules governing receiverships are state specific and can vary between jurisdictions,[4] there are three broad types of receiverships: (1) statutory receivers, (2) custodial receiverships, and (3) special fiscal agents. Other types of receivers include rent receivers and receivers in aid of execution.[5]

Of these categories, a statutory receiver has the broadest powers. The statutory receiver has the power to acquire legal title of the debtor's assets and to liquidate and dissolve the debtor entity.[6] The power to acquire legal title and to dissolve a business is the critical distinction between a statutory receiver and the other types of receiverships. When a court appoints a statutory receiver, it is not uncommon for the retention order to provide broad powers to the receiver, such as the authority to continue to operate the business, assume or reject unexpired leases, sell assets, collect rents, and have the power to close the debtor's business.

The grounds for the appointment of a statutory receiver is generally found where the corporation is insolvent or where there is a showing that the corporation is being conducted in a way which is creating waste.[7] Typically, a creditor, a controlling shareholder or the corporation itself can bring an action for the appointment of a receiver.[8]

A custodial receiver has less power than a statutory receiver, but still has considerable authority to administer the assets of a debtor. While custodial receivers do not take title to the assets of the debtor and are not empowered to liquidate and dissolve a corporation, the custodial receiver is empowered to preserve the status quo and preserve the corporate assets for a definite period of time.[9]

Lastly, a special fiscal agent enjoys the least amount of powers when compared to the statutory or custodial receiver. A special fiscal agent oversees the disbursements of a solvent corporation during the pendency of litigation, also known as a "pendent lite" device.[10] Thus a special fiscal agent's main function is to preserve the entity's assets and manage the debtor's business affairs. Among other duties, a special fiscal agent is typically appointed in order to investigate and protect the corporate assets and to carry on the business until a particular business dispute is resolved, and make reports to the court regarding the corporation's viability and prospects for survival.[11]

A rent receiver is appointed in cases where a bank or secured lender holding a mortgage seeks the possession of the mortgaged premises in order to protect the collateral and prevent waste. As in the case of other types of receiverships, the appointment of a rent receiver is within the discretion of the Court. Courts will generally appoint a rent receiver where the mortgagor failed to insure the mortgaged premises, or failed to pay property taxes or is otherwise acting in a way that may cause irreparable harm to the property.[12] Of course, a rent receiver will also be appointed in cases where there is a showing of waste, fraud, bad faith, or the misappropriation of rents.[13]

Thus, once the court makes the appointment, the principle duties of a rent receiver will be to collect rents from any tenant living in the mortgaged premises, lease the premises, pay property taxes, pay any necessary insurance premiums so the property is properly insured, make all

4 In New Jersey, state court statutory receivers are governed under N.J.S.A. §§14A:14-2 and 14A:14-4.

5 There are also other specific types of receiverships as well. For example, in New Jersey, there is a special receivership for municipalities. N.J.S.A. §54:4-123 provides that a receiver can be appointed for the collection of rents and income from real property for the collection and satisfaction of delinquent municipal real property taxes. N.J.S.A. §54:4-124 provides the mechanics for the appointment of this type of receiver. Since these special types receiverships are beyond the scope of this article, these receiverships will not be further discussed herein.

6 *See e.g.* N.J.S.A. §14A:14-4; *see also* Hon. William A. Dreier and Paul A. Rowe, Esq., *Guidebook to Chancery Practice in New Jersey* (7th Ed. 2008) at 106.

7 *See e.g.,* N.J.S.A. §14A:14-2(2), stating that a receivership action can be brought on the grounds that (1) the corporation is insolvent; (2) the corporation has suspended its ordinary business for lack of funds; or (3) the business of the corporation is being conducted at a great loss and greatly prejudicial to the interests of its creditors or shareholders.

8 *See e.g.*, N.J.S.A. §14A:14-2(1), which states that a receivership action may be brought in the Superior Court by (1) a creditor whose claim is for a sum certain or for a sum which can by computation be made certain; or (2) a shareholder or shareholders who individually or in combination own at least ten percent of the outstanding shares of any class of the corporation; or (3) the corporation, pursuant to resolution of its board.

9 *See Ravin, Sarasohn, Cook, Baumgarten, Fisch & Rosen, P.C. v. Lowenstein Sandler, P.C.*, 365 N.J. Super. 241 (App. Div. 2003). *See also* Dreier and Rowe, *supra*. at 107.

10 *See e.g. Roach v. Margulies*, 42 N.J. Super. 243, 245 (App. Div. 1956); *see also Kassover v. Kassover*, 312 N.J. Super. 96, 100-101 (App. Div. 1998).

11 *See Id. See also* Dreier and Rowe, *supra*. at 107, *see also* Scrivo, Gallo and Gimigliano, *Special Fiscal Agents – Armed Peacekeepers*, New Jersey Lawyer, April 2014, at 37-38. For the use of special fiscal agents in other jurisdictions, *see also Fix v. Fix Material Co.*, 538 S.W 2d. 351, 357 (Mo. Ct. App. 1976) (in a case dealing with an alleged oppression of a minority shareholder, the Court listed several remedies, including the appointment of a special fiscal agent "to report to the court relating to the continued operation of the corporation, as a protection to its minority stockholders, and the retention of jurisdiction of the case by the court for that purpose"); *Holi-Rest, Inc. v. Treloar*, 217 N.W. 2d. 517, 527 (Iowa 1974) ("We deem it essential to appoint a special fiscal agent to take control of the corporation and its financial affairs in order to protect the short-term rights of it and the minority stockholder.").

12 *See e.g. Parker v. Williams*, 231 Ala. 569, 571 (1936) (holding that a receiver should be appointed "when it is made to satisfactorily appear that the mortgagor is in possession, collecting the rents, is insolvent, and permits portions of the mortgaged property to be sold for taxes, and fails or refuses to keep buildings on the property insured, as by the terms of his mortgage he agreed to do. In other words, the court will not refuse the appointment of a receiver, when, by so doing, irreparable loss may result to the mortgagee.").

13 *See e.g. Cortleyeu v. Hathaway*, 11 N.J. Eq. 39, 43-44 (Ch. Div. 1855) ("If the buildings have been burnt down, or have been permitted to decay, or waste committed, and the property has depreciated in value through the fault or negligence of the mortgagor or tenant in possession, or where there is any act on the part of the mortgagor or such tenant shows fraud on his part, or makes him chargeable with bad faith in misappropriating the rents and profits for other purposes than that of keeping down the interest on the encumbrances, in such cases the court may very properly appoint a receiver."). *See also Horner v. Dey*, 61 N.J. Eq. 554, 557 (Ch. Div. 1901) (stating that "[a] depreciation in value by the act of the tenant in possession, or an act which shows fraud or makes him chargeable with bad faith in misappropriating the rents or profits, will, in some cases, lead the court to appoint a receiver.").

Continued from p.7

necessary repairs and otherwise take whatever actions are necessary to preserve the mortgaged property from further waste and deterioration.[14]

Finally, a receiver in aid of execution[15] is a remedy under state law to assist judgment creditors in enforcing their money judgment. While the powers of the receiver in aid of execution may overlap with some of the powers of the other types of receivers discussed above, a receiver in aid of execution will generally be granted powers to compel discovery of the judgment debtor and take whatever actions necessary to satisfy the outstanding debt.

While the various types of receivers generally fall into one of these categories, it should be noted that the circumstance of each case will dictate what powers should be included in the particular order retaining the receiver.[16]

In addition to state court receivers described above, receivers are also used in federal cases and are highly utilized in recovering assets for victims of financial fraud, most notably Ponzi schemes.[17] In federal receivership matters, the SEC would request that the district court appoint a receiver to assume control over a business and its assets.[18] Receivers appointed at the SEC's request "are directed to 'marshal the assets' of the defendant" and "prevent the dissipation of [the] defendant's assets pending further action of the court."[19] Thus, federal receivers are equipped with a variety of tools to help preserve the status quo while allowing them to determine and ascertain what has transpired.[20] Like the case of a state court receivership, a district court will craft an appropriate order to address the facts of each particular situation.[21]

14 *See e.g. Receivers of New Jersey M.R. Co. v. Wortendyke*, 27 N.J. Eq. 658, 662-663 (E. & A. 1876) (stating that "[t]he ordinary duties of a receiver in a foreclosure suit are in aid of the mortgagee, by collecting the rents and preserving the property from loss and decay.").

15 The appointment of a Receiver in Aid of Execution is governed in New Jersey under N.J.S.A. §2A:17-66 and is discussed in *First National State Bank v. Kron*, 190 N.J. Super. 510 (App. Div. 1983).

16 For example, in *State v. East Shores, Inc.*, 131 N.J. Super. 300 (Ch. Div. 1974), the Court permitted a custodial receiver to transfer legal title of the corporate assets for liquidation so it could obtain the funds necessary to comply with an order of the Board of Public Utility Commission requiring it to provide portable water to its customers and to institute an engineering study. *See also State Bd. of Public Utilities v. Valley Road Sewerage Co.,* 295 N.J. Super. 278 (App. Div. 1996) (granting the custodial receiver the authority to sell the assets of the corporation.).

17 *See* Lowenstein, Carl H. and Gerard, Michael, *Court Appointed Receivers for Ponzi Schemes*, New York Law Journal, (Volume 240, No. 125) (December 30, 2008).

18 *SEC v. Am. Bd. of Trade, Inc.*, 830 F.2d. 431, 436 (2d. Cir. 1987) (recognizing that "[a]lthough neither the Securities Act of 1933 nor the Securities Exchange Act of 1934 explicitly vests district courts with the power to appoint trustees or receivers, courts have consistently held that such power exists.").

19 *Eberhard v. Marcu* 530 F.3d. 122, 131 (2d. Cir. 2008) (internal citations omitted).

20 *Id*.

21 For an example of such type of order, *see e.g. United States SEC v. Estate of Saviano*, 2014 U.S. Dist. LEXIS 143714*; 2014 WL 5090787 (E.D. Mich. 2014).

Receiverships have many advantages. First and foremost, the appointment of a receiver is often times cost effective and provides for an efficient process.

Another benefit, from a creditor standpoint, is the fact that a receiver actually replaces the debtor's management. Thus, unlike a chapter 11 bankruptcy reorganization, where present management remains in place, a creditor may prefer that a receiver be appointed and replace the board of directors if the creditor perceives that the debtor's financial difficulties were caused by the debtor's management.

Finally, if the receiver is tasked with the responsibility of continuing to operate the business for a certain period of time, a receivership may be beneficial since receiverships have less perceived stigma than a bankruptcy case. The reduced stigma may assist the receiver in continuing the business relationships with the debtor's key vendors while the receiver operates the business or is otherwise administering the estate.

Despite these benefits, however, receiverships have drawbacks. One such drawback is that there is no automatic stay to prevent the creditors from pursuing their collection activity against the debtor. Of course, the imposition of the automatic stay is one of the hallmarks of a bankruptcy filing, which gives the debtor some "breathing room" to reorganize its affairs without the interruption and distraction of creditor enforcement actions against the debtor. Often times a receiver may seek a temporary restraining order and/or permanent injunction against such collection activity, which has the same effect as a stay.

Also, since a receivership is a creature of state law, the receivership proceeding can control only those creditors located within the jurisdiction where the receivership is pending. Thus, unlike a bankruptcy proceeding where all parties are joined in a concentrated and singular judicial forum, in a receivership, parties are free to commence or continue prosecution of their lawsuit in jurisdictions other than where the receivership is venued. Even in states where the receivership imposes an injunction on lawsuits, such an order may not be enforceable in states outside the jurisdiction where the receivership is pending.

Depending on the state law at issue, receivers may not have the authority to assume, assign or reject executory contracts, as in the case of a federal bankruptcy proceeding. Also, and depending on the state law, a receiver may not have the power to sue to recover preferential payments made to creditors. Of course, even if the state law does not provide for such powers, the receiver can request that the court include such powers in the receiver's retention order.

## Conclusion

Despite some of these drawbacks, the appointment of a receiver is an excellent alternative to a formal bankruptcy case when considering the flexibility, cost and speed in which the receiver can be appointed and fulfil his or her duties to address the issues in each particular case. Receivers are particularly useful in cases involving secured lenders who need to take control of their collateral quickly or in cases involving shareholder lawsuits who need the business to continue running smoothly pending the resolution of the their dispute, and even as a remedy for a single creditor trying to enforce its claim. The use of a court appointed receiver in federal cases involving the SEC is invaluable in helping victims of financial fraud to recover their assets.

In short, receiverships are a useful tool for an insolvency practitioner and should be given due consideration.


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### Steven Mitnick

Steven Mitnick is an attorney and founder of SM Law, PC where he specializes in business insolvency and liquidations and debt collection. Over the course of his 35 years in the industry, Mr. Mitnick has personally handled more than 300 assignments for the benefit of creditors proceedings, as well as receivership actions and all forms of corporate wind downs. His clients include bankruptcy trustees, assignees and receivers and he has served as a court appointed Chapter 11 trustee, receiver, special fiscal agent and assignee for the benefit of creditors in numerous federal and state court insolvency proceedings.

### Marc D. Miceli

Marc D. Miceli is an attorney and serves as of-counsel to SM Law, PC where he focuses on all areas of insolvency and bankruptcy law, including corporate liquidations and asset recovery. As part of his practice, Mr. Miceli routinely represents court appointed assignees in state court assignments for the benefit of creditors proceedings involving business liquidations as well as purchasers of distressed assets and Chapter 7 trustees before the U.S. Bankruptcy Court.

# Sales Under Article 9 of the Uniform Commercial Code

**MATTHEW A. OLINS**
*Duane Morris LLP*

Among the remedies that Article 9 of the Uniform Commercial Code provides to a secured party is the right, under Section 9-610, to sell personal property collateral after default.[1] This non-judicial remedy allows a secured party to monetize its collateral and apply the proceeds to its debt, or to credit bid all or a portion of its debt and purchase title to its collateral. Article 9 provides flexibility to secured parties as to the form of the sale. It may be public or private, by one or more contracts, in one or more parcels, at any time or place, and on any terms, so long as it is commercially reasonable. A sale conducted pursuant to the provisions of Article 9 transfers all of the debtor's rights in the collateral to the purchaser, discharges the security interest under which the sale is made, and discharges junior security interests (other than any liens that applicable law provides are not discharged, *see, e.g.*, Section 9-617(a)(3) as adopted by applicable state law).

One of the first steps that a secured party should take when selling its collateral is to review the default and remedy provisions of its loan documents. The secured party should confirm that it has complied with all applicable notice and grace periods before commencing enforcement proceedings. The secured party should also review the granting language of its security agreement to confirm the extent of the collateral, and confirm that its financing statement has not lapsed and all the information it contains is correct. Finally, if the secured party is a party to any intercreditor agreement, it should confirm that it has complied with all of its applicable provisions.

When planning the sale, a secured party should always consider its duty of commercial reasonableness. Indeed, as Section 9-610(b) states,"[e]very aspect of a disposition of collateral, including the method, manner, time, place, and other terms, must be commercially reasonable." Commercial reasonableness is a question of fact. However, with respect to the manner of the sale, Section 9-627(b) does provide some specific examples of commercial reasonableness including sales made: "(1) in the usual manner on any recognized market; (2) at the price current in any recognized market at the time of the disposition; or (3) otherwise in conformity with reasonable commercial practices among dealers in the type of property that was the subject of the disposition." (1) and (2) above are generally limited to sales of fungible property that can be sold through recognized exchanges.

Section 9-627(c) provides that a sale is commercially reasonable if approved in judicial proceeding or by a bona fide creditors' committee, a representative of creditors, or an assignee for the benefit of creditors. However, such approvals are not required to prove commercial reasonableness and may even be uncommon in sales under Article 9. The fact that a higher price may have been obtained by another method or at a different time does not, by itself, mean that the sale was not commercially reasonable.

Next, the secured party must send an authenticated notification of disposition. Section 9-613 sets forth the required contents of the notice, and also provides the basic form of notice that the secured party may adapt for its sale. Section 9-611 sets forth the parties that must be notified, which include the debtor, any secondary obligor, any person who sent the secured party an authenticated notification of a claim of interest in the collateral, and other secured parties with perfected security interests as of ten days before the notification date who perfected either through the filing of a financing statement or by other applicable law. In order to comply with the notification requirement to other secured parties who have filed financing statements, Section 9-611(e) provides (in language that should be clarified) a "safe harbor" setting forth the procedure for ordering a search of the records. Whether the secured party sends the notice of disposition within a reasonable period of time is a question of fact; however, Section 9-612 provides a "safe harbor" for notices sent after default and ten days or more before the earliest time of the sale. The secured party should also consult its security agreement for any alternative notice requirements. If the collateral is perishable, threatens to decline speedily in value, or is of the type customarily sold on a recognized market, the notification of disposition otherwise required by Section 9-611 is unnecessary.

When determining the type of sale, the secured party should always consider what is most commercially reasonable. In some situations, it will be a public sale, which is open to the public and provides the opportunity for competitive bidding. For such sales, the secured party should provide public notice, such as advertising the sale in one or more appropriate publications. Notifying other potentially interested parties of the sale may also be appropriate. However, there may be situations where a

1 All article and section references are to the Uniform Commercial Code. This article is intended to provide a brief, general summary of, and some suggestions for, the sale process under Article 9 for non-consumer goods transactions (transactions involving consumer goods have certain separate requirements). Practitioners should consult all applicable law, including the Uniform Commercial Code as adopted in their states, before conducting a sale under Article 9.

private sale will result in a higher price; therefore, so long as it is commercially reasonable, the sale may be private. For such private sales, the secured party will want to be able to prove that it made reasonable efforts to find interested buyers. If the collateral is of a kind that is customarily sold on a recognized market or the subject of widely distributed standard price quotations, the secured party may even purchase it at a private sale; however, these transfers are rare and are usually made under the strict foreclosure procedures of Article 9. It should also be noted that Section 9-610(d) provides that contracts for sale include certain warranties that are included by operation of law in voluntary dispositions. Significantly, however, Sections 9-610(e) and (f) provide instructions for how the secured party may disclaim such warranties.

If the sale is a public auction, the secured party will generally want a court reporter present to generate a transcript of the proceeding. The secured party will have flexibility in where, when, and how the auction is conducted, so long as it is commercially reasonable.

Section 9-615 provides the waterfall for the proceeds of the sale after receipt by the secured party. First they are applied to the reasonable expenses of the secured party (including attorney's fees and legal expenses if provided for by agreement and not prohibited by other law), second is to the satisfaction of the obligations secured by the security agreement (*see* Section 9-615(a) for consignor provisions), third is to subordinate security interests in certain circumstances, and fourth is to the debtor subject to the exceptions of Sections 9-615(e) and (f). In order for a holder of a subordinate security interest to receive proceeds from the sale from the secured party after payment of senior claims, it must make an authenticated demand upon the secured party for proceeds prior to their distribution by the secured party. If the proceeds of the sale are insufficient to satisfy the debt, subject again to the exceptions of Sections 9-615(e) and (f), the obligor is liable to the secured party for the deficiency. Section 9-615 does not require the payment of senior lien holders if the sale is conducted by a junior lien holder; however, the senior lien will not be extinguished nor will a senior lien holder lose its other rights with respect to the collateral (including its right to repossess and sell) once it is transferred to the transferee unless the senior lien holder consents. A similar result arises in a sale by a lien holder of equal priority.

A transfer statement, made pursuant to Section 9-619, entitles the transferee to the transfer of record of all rights of the debtor in the collateral that it purchased in any official filing, recording, registration, or certificate-of-title system covering the collateral. The transfer statement is a record, authenticated by the secured party, stating: (1) that the debtor has defaulted in connection with an obligation secured by specified collateral; (2) that the secured party has exercised its post-default remedies with respect to the collateral; (3) that, by reason of the exercise, a transferee has acquired the rights of the debtor in the collateral; and (4) the name and mailing address of the secured party, debtor, and transferee.

Upon completion of its sale, the secured party is free to pursue any other remedies available to it by law, including bringing separate actions for deficiency against the obligors.


ABOUT THE AUTHOR

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Matthew Olins is a partner in the Chicago office of Duane Morris LLP. Mr. Olins practices in the areas of business reorganization, financial restructuring, commercial finance, secured transactions, and creditors' rights. He represents lenders, special servicers, and various types of other business organizations in loan workouts, business bankruptcy cases, commercial finance transactions, commercial foreclosures, and litigation. Mr. Olins also represents business organizations in reorganizations and liquidations.

# Delaware as a Venue for ABCs: Some Pros and Cons[1]

**GEOFFREY L. BERMAN,**
*Development Specialists, Inc.*

Much has been said about the use of non-bankruptcy alternatives over the past few years, as the number of Chapter 11 filings has decreased, costs of bankruptcy proceedings have risen and uncertainty as to outcomes once again becomes a critical factor in deciding how to address distressed debtor issues. In addition, there is the slowly increasing interest rate environment, with the Federal Reserve having raised the base rate by 25 basis points in March and strongly hinting at two more rate increases before year end. Borrowers who were barely covering cash flow requirements, including debt service, will now have a more difficult time making debt service payments. Couple this environment with the sheer volume of debt placed on businesses when capital sources were plentiful and it is no wonder that businesses are facing ever-increasing demands for resolving needs for new capital or debt without a good deal of success. With this backdrop, the use of Assignments for the Benefit of Creditors (ABCs) is an alternative that is garnering more and more attention.

An ABC is a state law governed liquidation process that in many respects follows the process in a Chapter 7 bankruptcy proceeding. But as the prior sentence reflects, applicable state law versus federal bankruptcy law controls. The assets of the debtor (or "assignor") are assigned to an individual (including a company that acts in the fiduciary capacity as an assignee) for the purpose of liquidating the assigned assets. All assets of the debtor must be assigned to make the assignment a general assignment and enable the assignee to take advantage of the protections provided under the applicable sections of the UCC.[2]

ABCs differ from receiverships and Article 9 sales in a number of respects. First, ABCs are not "a creditor remedy" in that creditors cannot force a debtor to make a general assignment. Secured creditors can push a distressed debtor to this alternative, but the decision to make an ABC belongs solely to the debtor's Board of Directors and shareholders. Second, some states do not have court supervision of an assignee in their role in liquidating a debtor; however, there are a number of states that do have judicial supervision of the ABC process.

Receiverships are however a creditor remedy, typically sought by a creditor with some form of lien rights against collateral it wishes to protect. Be it by consent from a debtor (through the loan documents or otherwise) or the creditor seeking the appointment of a receiver on an expedited basis, the debtor is not the party usually agreeing to the appointment of the receiver. Receivers are officers of the court that appointed them, but their duty generally runs to the creditor that sought the receiver's appointment.

Article 9 sales are also a secured creditor remedy, again usually initiated by the secured lender through a foreclosure process on its collateral and after having declared the underlying debt in default. A debtor may "consent" as part of a negotiated resolution of its debt, but as with receiverships, the debtor does not control the use of the alternative or the choice of the fiduciary.[3]

Generally, state laws governing ABCs do not provide for an automatic stay stopping any litigation against the debtor. That type of relief is solely within the purview of bankruptcy. But state law will enable the assignee to sell assets, prosecute claims against third parties to recover from those third parties, including choses in action, for example claims for breach of contract, claims against directors and officers and in some states even the recovery of preference-type claims.[4]

A number of states are undertaking review of ABC laws including Missouri and Maryland who are currently working on new statutory schemes for ABCs. With the increasing use of ABCs, there is a growing trend to employ the assistance of the Delaware Courts of Chancery for the supervision of these cases. The corporate friendly backdrop of Delaware law generally and the familiarity of the Courts

1 This article accompanies other articles focusing on receiverships and Article 9 sales published in this edition of *AIRA Journal,* Vol. 31: No. 2 (2017).

2 *See* Article 9-309(12) for an assignee to have the rights of a lien creditor upon the making of the general assignment.

3 Readers are again referred to companion articles in this edition of *AIRA Journal* for more specific information on these alternatives.

4 Such actions are subject to both state law and any applicable appellate decisions. For example, *see Sherwood Partners V. Lycos*, 394 F.3d 1198 (9th Cir. 2005) which invalidated California Code of Civil Procedure Section 1800; but compare *Credit Managers Association v. Countrywide Home Loans*, 144 Cal. App.4th 590 (2006).

of Chancery (and of course the bankruptcy court) with the ABC alternative make the use of Delaware a logical choice where one is dealing with a Delaware corporation whose principal place of business might be in a state that is less "user friendly" for the ABC process. Having a Delaware corporation as the assignor will generally give the Court of Chancery jurisdiction over the assets and enable the Court to "accept" the petition and Trust Agreement. Having an Assignee that is a Delaware entity does not hurt either.

With this in mind, there are a few considerations counsel to a distressed debtor will want to take into account when looking at the Delaware alternative. First, on the "pro" side is the use of a jurisdiction that understands the ABC alternative and is not quick to suggest the case belongs down the street at the Bankruptcy Court. Creditors recognize the authority of the Court of Chancery and orders from the Court carry a gravamen that creditors respect. This gives creditors a comfort that there is a good basis for the proceeding, competent judicial oversight, etc.[5]

There are processes in place for the Assignee to post a bond, requirements for appraising inventory assets, notice requirements and accounting of the activity undertaken in connection with the assignment process. Delaware courts have upheld arbitration clauses in contracts between an assignor and a third party, enabling an assignee to use arbitration as a means of avoiding the costs and time delays attendant with court trials.[6] Additionally, the Delaware Courts and Bar Association provide a wealth of restructuring experience.

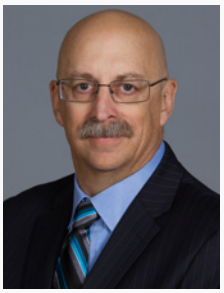
There are, of course, drawbacks. As noted, the Assignee bond requirement, inventory appraisals and the need for counsel that participates in court proceedings makes the process more expensive than those states that do not have a judicial oversight component. The author has seen cases where the bond requirement has been waived, though that will usually require the consent of the secured creditor. The same is true with the appraisal requirement.[7]

ABC's provide a sale alternative to bankruptcy 363 sales processes. As with 363 sales, selling assets in a Court of Chancery proceeding requires notice of the sale process, a reasonable marketing effort pre- or post-assignment that the Court finds acceptable and maybe, most importantly, giving creditors sufficient notice of any hearing to approve a sale so as to satisfy the Court's concerns about due process. This means that a quick sale is almost impossible. Further, the Court of Chancery has no statutory basis for entering an order selling the assets "free and clear"; that of course is a bankruptcy concept and any state court order providing for such relief would be subject to an argument of being preempted by the Bankruptcy Code or a violation of the Contracts Clause of Article I of the U.S. Constitution.[8]

Such sales take planning, appropriate pleadings and supporting declarations or affidavits and counsel time. Counsel time means costs. So parties going into a Delaware ABC need to take these additional factors into account when planning and budgeting for using Delaware for an ABC.

What does all this mean? A Delaware ABC is a very viable alternative to states where the ABC process is less "user-friendly." The process requires more planning, good counsel for all parties and an understanding of the timing and process to make the ABC case run smoothly. Knowing the process, relying on good counsel and the credibility of the Court of Chancery with creditors make Delaware a good choice for ABCs.[9]


ABOUT THE AUTHOR



**Geoffrey L. Berman**

Mr. Berman is a Senior Managing Director of Development Specialists, Inc. He is a former President and Chairman of the Board of the American Bankruptcy Institute, Alexandra, VA and ex-officio member of the ABI's Commission to Study the Reform of Chapter 11. He is also the author of General Assignments for the Benefit of Creditors: The ABCs of ABCs, Third Edition (edited by David Gould; American Bankruptcy Institute (2015)), along with other articles and treatises on ABCs. Mr. Berman would like to thank John Knight and Paul Heath of Richards Layton & Finger for their review and comments to this article.

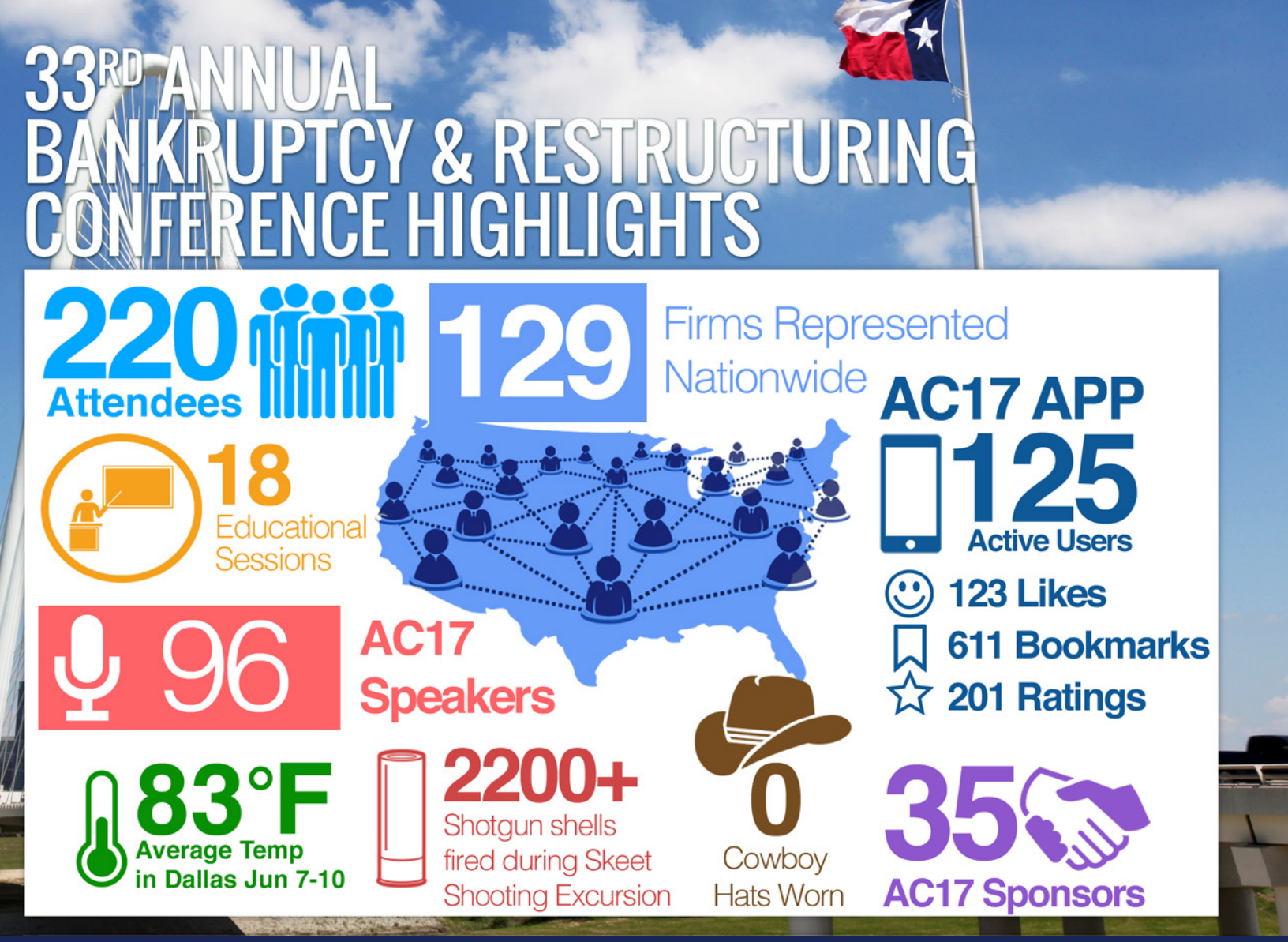

5 This is not to say other states with judicial oversight of ABC cases do not have competent judges handling the cases; however, ABC cases in many states are small in number or are assigned to trial courts with little commercial liquidation or even probate case experience.

6 *See CVD Equipment Corp. v. Development Specialists Inc.*, No. CV 11062-VCG, 2015 WL 4506052, 2015 Del. Ch. LEXIS 193 (Del. Ch. July 23, 2015) (unpublished).

7 The waiver of the inventory appraisal is becoming more prevalent where the secured creditor is significantly under-collateralized and has a recent appraisal, thereby reducing, if not eliminating, the need for additional appraisals or, as in a recent case, where the assignor was a drop ship e-tailer with no inventory.

8 The taking of a property right without providing the creditor with due process to protect their property right.

9 Additional information on ABCs generally can be found across the Web. See also, *General Assignments for the Benefit of Creditors: The ABCs of ABCs, Third Edition,* by Geoffrey L. Berman, edited by David Gould (American Bankruptcy Institute (2015)); available at www.bookstore.abi.org




# Jay Crom Receives Manny Katten Award

June 8, 2017, Dallas TX – The Association of Insolvency and Restructuring Advisors presented the Manny Katten Award to Jay D. Crom, CIRA – Managing Partner of Bachecki, Crom & Co., LLP – for exemplary contributions to the Association and the insolvency and restructuring profession. The award took place during the Annual Banquet of AIRA's 33rd Annual Bankruptcy & Restructuring Conference, at the Four Seasons Resort & Club Dallas-Las Colinas. Introducing Jay to receive the award, Elizabeth C. Berry, CIRA (Elizabeth C. Berry CPA, PLLC) acknowledged his "years of dedication to the profession and AIRA while also managing a successful San Francisco accounting firm and raising a family."

Jay was a member of the second CIRA class in the mid-90's and from the outset was very involved with AIRA, becoming an active member and supporter for over 20 years. He began speaking regularly on the Bankruptcy Tax program in 2005 and since then has taken over the momentous task of planning the tax program as well as participating as speaker and serving on other AIRA committees.

Jay heads up Bachecki Crom's litigation support and is active in the firm's tax consulting services, having practiced extensively in forensic accounting, business valuation, recoverable fraudulent transfers and insolvency accounting, among others. He has been an Examiner in numerous chapter 11 cases, admitted as expert in various courts, and frequent speaker on tax and forensic matters. Other affiliations include AICPA, California Society of CPAs, California Receivers' Forum, National Association of Bankruptcy Trustees, and Bay Area Bankruptcy Forum.

# 2017 ZOLFO COOPER AWARDS

Medals for the Zolfo Cooper Awards and Certificates of Distinguished Performance were conferred upon candidates who earned the top composite scores for all three parts of the CIRA exam completed by end of the previous year.

## Gold Medal

**Robert McLeod,** Alderney Advisors, *Southfield, MI*

Robert W. (Rob) McLeod is a senior financial executive with extensive experience in merger and acquisition due diligence, financial and strategic options analysis, and restructuring and turnaround advisory. He serves as Managing Director of Alderney Advisors, a leading business advisory firm lighting the way for companies, lenders, investors, and other advisors as they navigate high-stakes challenges and opportunities. He earned his BBA in Accounting and Finance from the University of Michigan Ross School of Business.

## Silver Medal

**Patryk Szafranski, CIRA,** AlixPartners, LLP, *New York, NY*

Through unique combination of financial and operational skills, Patryk delivers holistic solutions focused on quick rebuilding of trust and shareholder value. He specializes in cash management, business plan modelling, headcount and cost optimization driven by business process improvement. Speaking five languages, he combines comprehensive financial and legal education with sound understanding of cross-cultural aspects of change management. Patryk is an MBA graduate from London Business School, and holds a PhD in Insolvency Law.

## Bronze Medal

**Justin Carroll, CIRA,** Guggenheim Partners, *New York, NY*

Justin is a member of a team that handles transactional matters for Guggenheim Partners Investment Management, including loan origination, private fund and separately managed account formation, leverage finance structuring and negotiation, private placements, M&A, venture capital investment, creditor's rights, corporate governance, and special-situations analysis. Justin specializes in distressed investments, bankruptcies, workouts and reorganizations. He received his A.B. in Politics from Princeton University, and J.D. from Columbia University School of Law.

# CERTIFICATES OF DISTINGUISHED PERFORMANCE

**Thomas Grigg,** FTI Consulting, Inc, *Los Angeles, CA*

Thomas Grigg is a Director at FTI Consulting, Inc in Los Angeles where he is a member of the Corporate Finance and Restructuring group. He has more than seven years of turnaround and performance improvement experience in a variety of sectors, including retail, manufacturing, education, property, and leisure. He has worked with clients on efficiency initiatives, project management, corporate restructuring and financial forecasting engagements. He holds a Bachelor of Commerce and Bachelor of Arts from the University of Melbourne.

**Josh Beets,** FTI Consulting, Inc, *Dallas, TX*

Josh is a director in FTI's Corporate Finance practice based in Dallas. While at FTI he has worked on a variety of restructuring engagements, primarily in the oil and gas industry. He has represented creditors holding over $5.8 billion of debt. Prior to joining FTI he worked as a commercial banker for four years with BBVA Compass and Citizens Bank. He holds a Bachelors of Music with Elective Studies in Business from Wheaton College and an MBA in Finance from the University of Texas at Austin.

**Nicholas Bugden,** Ernst & Young LLP, *Chicago, IL*

Nick Bugden is a Manager in Ernst & Young's Transaction Advisory Services group. He began his career in the firm's valuation and business modeling practice before transitioning to EY Restructuring in 2012, where he has assisted companies and municipalities both in and out of court. Nick graduated magna cum laude from the University of Notre Dame's Mendoza College of Business. He currently lives in Old Town, Chicago and enjoys annual trips abroad.

**Cole Broskay,** Alvarez & Marsal, *Houston, TX*

Cole Broskay is a manager with Alvarez & Marsal's CFO Services solution. While with A&M, he has primarily served as an oil and gas carve-out lead, managing various finance, accounting and operational functional areas in support of the asset transaction and entity stand-up. Prior to A&M, his industry experience was focused in operations management and process improvement primarily in the oil and gas services industry. Cole received his MBA from Rice University and his Bachelor's degree from Texas A&M.

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Zolfo Cooper is the world's preeminent financial advisory and interim management firm, dedicated to providing restructuring leadership to companies and their stakeholders. For over 30 years, Zolfo Cooper professionals have helped clients resolve their most complex, high-stakes business problems. Whether stepping in as interim management, advising a company's lenders, leading a restructuring or identifying risks arising from disputes, Zolfo Cooper delivers results — from maximizing value to enhancing a company's long-term competitive advantage. With offices and affiliations in the world's leading financial centers, Zolfo Cooper assists clients spanning the middle-market to the largest and most complex cross-border situations.

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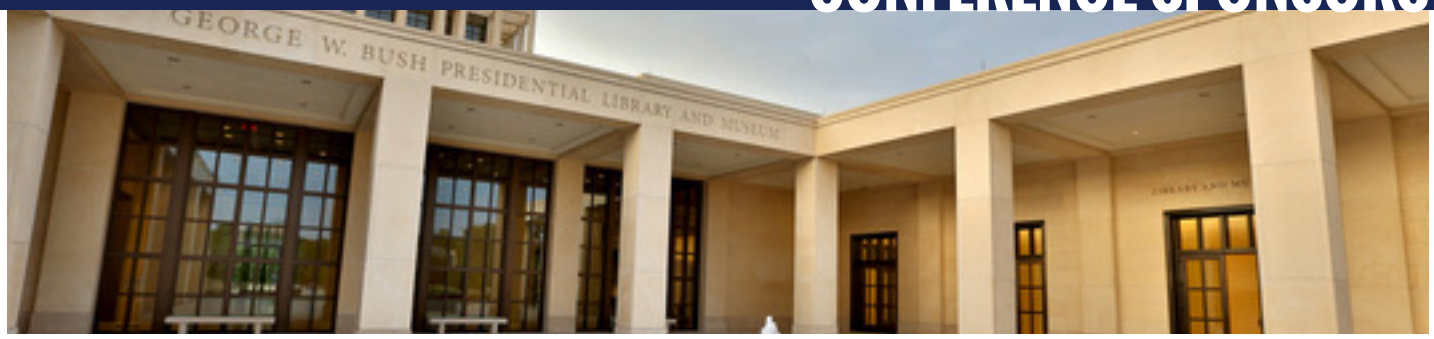


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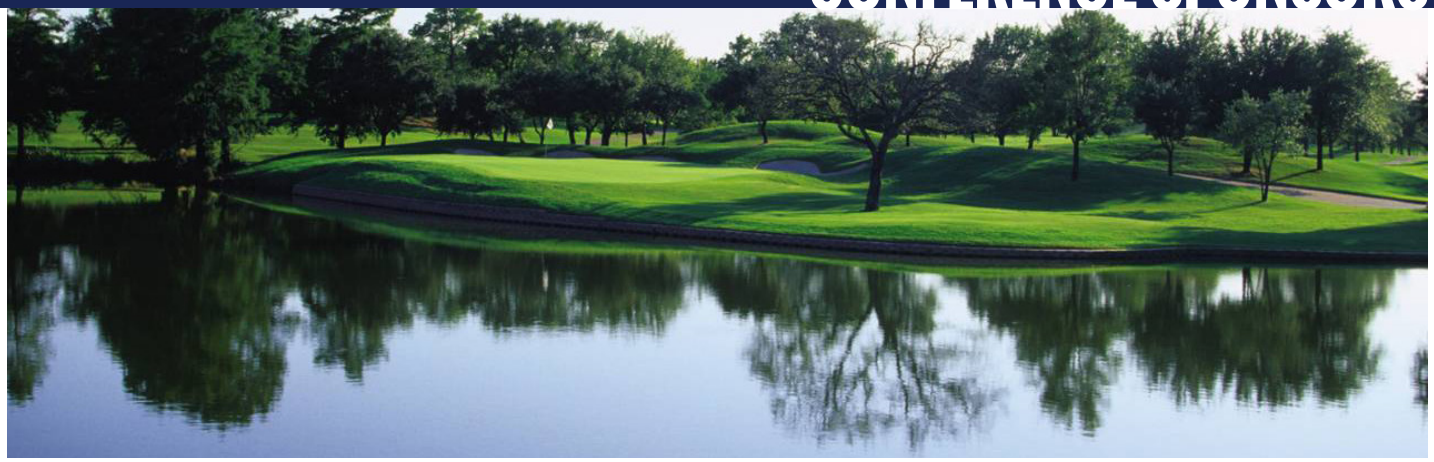

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RSM US LLP is the leading U.S. provider of assurance, tax and consulting services focused on the middle market, with 8,000 professionals and associates in 80 cities nationwide. RSM's litigation consulting and dispute advisory practice is a team of credentialed, seasoned professionals who provide objective insight and support to counsel and their clients involved in high-stakes disputes, including complex litigation, business valuation, regulatory actions, cross-border investigations and other forensic accounting matters. We also provide data management and analysis, including database design, development, and data mining. Our professionals have advised clients and testified as expert witnesses on some of the highest-profile litigation and arbitration matters in state, federal and international courts and forums.

Barg & Henson, P.C. was formed in 1984 as a Boutique tax consulting and compliance firm providing Federal and State tax consulting, compliance and related accounting services to selected client engagements most of which are located throughout the Dallas/Fort Worth Metroplex. A significant number of our engagements occur in connection with support services related to bankruptcy and insolvency tax matters in both formal court proceedings and in out of court settlements. Our staff of eight is highly qualified. Two of our members hold Certified Insolvency and Reorganization Advisor (CIRA) credentials, five have Masters degrees in Taxation or in Accounting and both named stockholders have a combined experience of over 20 years with international "Big Four" accounting firms.

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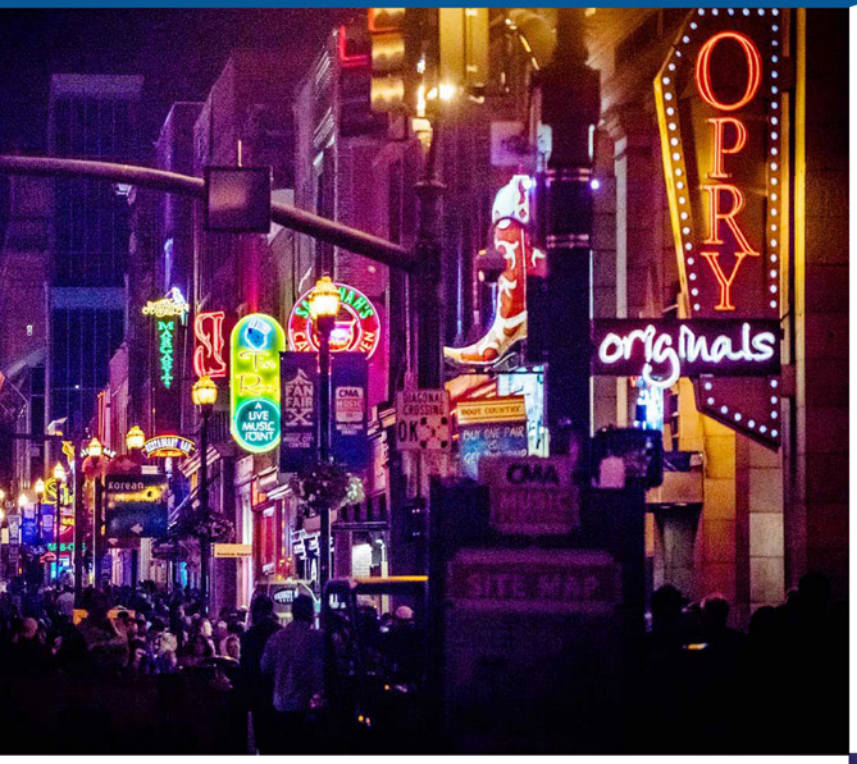


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# Bankruptcy Taxes

Section Editor:
David Sterling, *RSM US LLP*

## What Are a Receiver's Federal Income Tax Filing Responsibilities and Liability?

**BRIAN J. HEISMAN**
*RSM US LLP*

In law, receivership is a situation in which an institution or enterprise is held by a receiver—a person placed in the custodial responsibility for the property of others, especially in cases where a company cannot meet financial obligations or enters bankruptcy. A receiver's obligations and liability with respect to federal income taxes can be complex depending on varying circumstances including the jurisdiction of the proceeding, the type of company in receivership, the priority of payment of tax and other liabilities and filing requirements.

### *When Is a Receiver Personally Liable for Federal Taxes?*

A receiver's responsibilities are generally guided by federal, state and local judicial codes and statutes, Treasury and other state and local tax regulations, and case law. A receiver's failure to execute its duties (which are generally similar to fiduciary duties and include any financial interests effecting information on the tax returns) can result in personal liability for the receiver for the tax obligations of the receivership.[1] Note that such liability can include not just current returns but also past returns due before the receivership.

### *When Does a Receiver Need to File Tax Returns?*

#### Substantially All of the Assets

Generally, a receiver of a company is responsible for preparing and filing all current and prior unfiled returns for a taxpayer when the receiver has custody or control over all (or substantially all) of the assets.[2] Additionally, although full tax returns may not always be required, for most companies the receiver will be required to file at the least informational returns.

#### Qualified Settlement Funds

Even though a receivership is generally not a separate taxable entity, a receivership that constitutes a qualified settlement fund ("QSF") is treated as a separate taxable entity requiring the filing of IRS Form 1120-SF, U.S. Income Tax Return for Settlement Funds. A QSF is generally a fund, account, or trust that is set up by court order, is created as a result of a violation or claimed violation of the law, and is held in a segregated account.[3] If the property within the custody and control of the receiver meets the statutory definition of a QSF, the receiver is required to file tax return(s) and, if necessary, pay taxes.

### *Can a Receiver Have Its Filing Responsibility Waived?*

Generally, statutory law prohibits courts from granting relief to companies / receivers whereby the IRS would be prohibited from collecting a tax liability when the case involves federal taxes[4] However, while both state and federal courts are unlikely to have actual legal jurisdiction over the IRS to enforce a granted order, there have been certain instances in which a receiver has been successful in obtaining a non-binding court order to have filing requirements waived (*e.g.*, lack of / inadequate books and records, fraudulent activity, no taxes due).

The reality is that in most instances, the IRS would likely not take action unless such receiver did not provide notice of the order or had been grossly negligent in not performing their normal duties; *i.e.*, what would be expected of a prudent and reasonable receiver. The IRS may even record in the system that no return is required upon notice of such an order.

#### Inadequate Books and Records

The IRS has signified that if income is underreported by 25% or more, it is akin to a return not having been filed, and the 3-year return statute of limitations will remain open. As a practical matter, this can be a tough requirement to follow if the receiver is having a hard time validating the numbers based on information provided, as it is generally expected that this would be possible for the receiver to accomplish.

1 31 U.S.C. 3713(b).
2 I.R.C. Section 6012(b)(3) and Treasury Regulation Section 1.6012-3(b)(4).
3 Treasury Regulation Section 1.468B-1(c). Note the QSF's state and local filing requirements will depend upon the particular state or local government where the fund is located.
4 28 U.S.C. Section 2201; 26 U.S.C. Section 7421.

However, some receivers have been successful in getting such filing requirements waived in these instances.

**Fraudulent Activity**

Even in the instance where a receiver is representing a fraudulent company, the receiver's responsibilities still include paying tax liabilities, filing returns, etc.[5] Nonetheless, some receivers have been successful in obtaining a waiver from such filing requirements for past returns due before the receivership if the company has been found to be fraudulent.

**No Taxes Due / No Assets**

A receiver, may apply to the IRS for relief from filing federal income tax returns if the company in receivership:

- ceased business operations,
- has no assets, and
- has no income for the tax year.[6]

## *What Order Must a Receiver File When Paying Out Liabilities?*

The receiver should be sure to review all controlling documents and determine the proper priority of payments, including tax claims. Generally, any claims of the U.S. Government, including taxes, must be paid first.[7] A receiver who pays debts to others before paying debts to the Government is liable to the Government to the extent of those payments. Further, in order to be personally liable the receiver generally must have known, or should have known with the exercise of diligence, of the Government debt.[8]

However, typically, reasonable administrative expenses such as attorney fees, court costs and expenses to operate a business may have priority over debts to the Government.[9] Additionally, perfected secured claims generally retain priority over unsecured federal claims.

## *Must a Receiver Give Notice of His / Her Appointment?*

A receiver is required to provide notice to the IRS of his or her appointment within 10 days if the receiver holds substantially all of the assets, or if the receivership constitutes a QSF.[10] Further, the statute of limitations for making an assessment may be suspended for up to 2 years, if no notice is given; otherwise it begins to run 30 days after the notice.[11]

## *Conclusion*

Receivers should carefully determine the type of receivership they are overseeing, give notice of their appointment, and be prepared to file tax returns or they may be personally liable.


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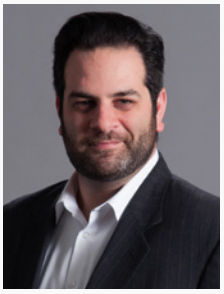

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5 Further, when fraud is involved, the IRS may also extend the statute of limitations to 6 years. Note that fraudulent activity can affect net operating loss (NOL) availability which opens up further past returns if there is a net effect on the NOL balance.

6 The exemption request must be submitted to the local IRS Insolvency Office handling the case.

7 31 U.S.C. Section 3713.

8 31 U.S.C. Section 3713(b). *Want v. CIR*, 280 F.2d 777 (2d Cir. 1960); *Little v. CCIR*, 113 T.C. 474 (1999); *United States v. Renda*, 709 F.3d 480 (5th Cir. 2013).

9 *United States v. State of Oklahoma*, 261 U.S. 253 (1923); *Southern Rwy. Co. v. United States* 306 F.2d 119 (5th Cir. 1962). The IRS even states in its Internal Revenue Manual that administrative expenses should be paid ahead of a federal tax lien.

10 Treasury Regulation Section 301.6036-1(a)(3). The notice must contain those items set forth in Treasury Regulation Section 301.6036-1(a)(4)(ii).

11 I.R.C. Section 6872.


# The Economic Balance Sheet and Its Application to Enterprise Valuation

**BORIS J. STEFFEN, CDBV**
*RSM US LLP*

The value of a firm must equal the value of the claims on its assets — in practice, this is generally expressed as the $\text{Value}_{\text{FIRM}} = \text{Value}_{\text{DEBT}} + \text{Value}_{\text{EQUITY}}$. Similarly, in a balance sheet prepared in accordance with Generally Accepted Accounting Principles (GAAP), Assets = Liabilities + Equity.

Comparison of the financial balance sheet with an economic balance sheet reveals several major differences. The latter is constructed using market values rather than amounts reported in accordance with GAAP. Items are classified as operating, non-operating, debt or equity-related, rather than current or long-term, asset or liability. Also, the economic balance sheet includes assets and liabilities not recognized under GAAP.

Insights derived from examining these differences can be useful in valuing an enterprise and understanding how its value is affected by the relationships among its assets, capital claims and cash flows.

## Fair Value and Fair Market Value

GAAP permits the use of various measurement bases, the most common of which are historical cost and fair value. With historical cost, firms account for assets on the basis of the initial acquisition price, and for liabilities based on the cost of the product or service received in exchange. Fair value, defined as the "price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date," is used for financial assets, and for nonfinancial assets and liabilities reported at fair value on a recurring basis.

Though the definition of fair value for financial reporting is similar to fair market value, there are subtle differences between the two that can result in not so subtle differences in value. Unlike fair market value, which contemplates an open and unrestricted market, fair value only considers participants in the principal or most advantageous market, who already own the asset or owe the liability. Fair value also differs in that it may account for synergies and for characteristics specific to a particular buyer or seller, and that it is an exit, rather than entry, price. Additionally, fair value refers to the value of an asset or liability as of a specific measurement date rather than a potential date in the future.

## Balance Sheet Classifications

### Core Business Operations

Assets that are essential to the operations of a company and could not be divested without impairing the ability of the firm to operate its primary business are classified as core

business operations ("CBO"). Within this category are monetary assets such as accounts receivable and required cash, physical assets like inventories, property, plant and equipment, and intangible assets including intellectual property. CBO are valued as ongoing business rather than individually as separate assets, as the value of a going concern is a function of the value created by a firm's operating assets acting together in combination, including the value of growth opportunities.

Non-interest bearing operating liabilities, including trade payables, taxes payable and unearned revenues, are also part of core operations. These liabilities arise when a firm is not required to pay cash for an operating expense in the same period the expense is incurred, or receives payment in advance of providing a good or service. Non-interest bearing liabilities are not considered separately in valuing a CBO, however, since in valuing a going concern they are netted against the firm's current assets in calculating its investment in non-cash operating working capital. The reason for this is that when a firm buys a product on credit, the interest charge is buried in the cost of the product and cannot be readily separated from the costs of operations.

**Non-Operating Assets**

Assets that are not needed or in excess of that required to operate the business being valued are non-operating, or excess, assets ("NOA"). Examples include excess cash and marketable securities, contingent assets, nonconsolidated subsidiaries, equity investments in other firms, discontinued operations, finance subsidiaries, net operating losses, joint ventures, real estate and net pension assets. As such, it can be seen that NOA are in general comprised of either marketable securities, which are marked to market, or illiquid assets carried at cost. Unlike the valuation of a firm's operating assets, non-operating assets must therefore be valued individually. The resulting values are then added to the value of core operations.

**Debt and Debt Equivalents**

In valuation, debt can be thought of as amounts that are contractually owed to other parties and that bear explicit or implicit interest that is measureable. Liabilities meeting these criteria include commercial paper, notes, mortgages, fixed and floating bank loans, bonds and capitalized leases. Claims treated as debt equivalents include underfunded pension liabilities and postretirement medical benefits, long-term operating reserves for plant decommissioning costs, non-operating reserves for restructuring charges and contingent liabilities stemming from environmental and product liability claims.

Off-balance sheet debt includes operating leases, unconditional purchase obligations and special purpose entities. Companies that lease their assets using operating leases are able to record the lease expense as rent in operating expense rather than capitalizing it as debt. Similarly, unconditional purchase obligations (i.e., take-or-pay or throughput contracts) to transfer funds in the future for fixed or minimum amounts or quantities of goods at fixed or minimum prices need not be recorded. Special purpose entities are in turn used to isolate and transfer risk from a firm's balance sheet to another entity, and in the case of securitized trade receivables, obtain financing at rates lower than other forms of debt.

**Other Capital Claims**

Other capital claims ("OCC") include all claims on the firm's assets not included elsewhere. This includes preferred stock, employee stock options, warrants and minority interest. Preferred stock is a type of security which entitles the owner to a fixed claim on the firm's assets. Dividends to preferred stock typically must be paid ahead of dividends to common equity, though preferred shares usually do not have voting rights. While junior in priority to debt, preferred stock is more like unsecured debt than equity for an established firm.

Firms frequently compensate employees with equity-based compensation. In a stock option program, employees receive options granting them the right to purchase a specified number of shares at a specific price over a certain period. A stock appreciation right entitles the employee to receive the value of the appreciation in the value of the stock between the grant and expiration dates, either in the form of cash, stock or preferred stock. In addition, a firm may compensate employees with restricted stock or restricted stock units. With restricted stock, employees receive stock that cannot be sold until whatever restrictions in place are lifted. No stock is issued with the grant of restricted stock units. The grant is satisfied with company stock or cash when considered appropriate.

A stock warrant is similar to a call option in that it is a derivative security that grants the holder the right, but not the obligation, to buy a specified number of shares at a specified price on or before a certain date. Unlike call options that are issued by investors to each other, however, a warrant is issued by a firm. The result is that the value of the firm's equity per share is diluted.

When a parent company owns more than 50 percent of a subsidiary, it must consolidate the subsidiary's financial statements with its own. Where the amount owned is less than 100 percent, however, the parent reports a deduction for the income or loss and common equity attributable to the ownership interest in the subsidiary that it doesn't own. This amount is referred to as minority interest.

**Common Equity**

Common equity ("CE") is the residual claim in the firm's value after all other claims have been satisfied. Notwithstanding, holders of CE typically control the firm, and elect the Board, who in turn hires management.

**Inclusion of All Economic Assets and Liabilities**

Assets and liabilities do not need to meet the criteria for recognition under GAAP to be included in an economic balance sheet. Rather, any economic resource or claim that would affect how much a buyer might pay for the firm should be counted. Environmental liabilities, which

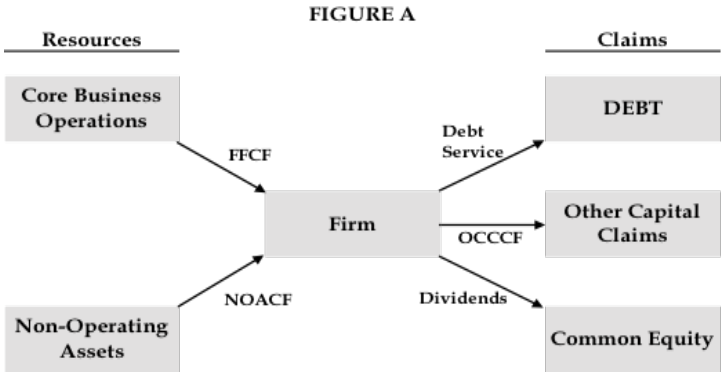
Continued from p.27

are recognized under GAAP only when it is probable that a liability has been incurred and the amount can be reasonably estimated, is one such example. Contingent assets associated with the proceeds from lawsuits, which are not recorded even when they are probable and can be estimated, is another.

## Relevance to Enterprise Valuation

As Figure A below illustrates, core business operations and non-operating assets produce cash inflows for the firm, while debt, other capital claims and common equity lead to cash outflows.

FIGURE A




Of equal import, it can be seen that the total value of claims, namely debt and debt equivalents, other capital claims and common equity, is equal to the total value of assets, which equals the sum of core business operations and non-operating assets, i.e.

**( 1 )** CBO + NOA = DEBT + OCC + CE

Rearranging terms yields the equation for the value of common equity, where:

**( 2 )** CE = CBO + NOA – DEBT - OCC

Applying this relationship to valuation depends on the method used. The value of common equity may be estimated directly using the dividend discounted cash flow method, while in the other four methods used, its value is a function of the cash flow and or values of the other claims in the equation. Each method will produce the same indication of value given the same assumptions, albeit with a different focus and perspective regarding elements that affect the value of the firm.

CBO generates firm free cash flow ("FFCF"), which generally speaking is the net of operating profit, taxes, working capital and capital expenditures. NOA produces non-operating cash flow ("NOACF") from items including dividends, interest, tax benefits (NOLs) and lawsuit settlements. Debt creates obligations to make interest and principal payments ("DEBT SERVICE"). OCC gives rise to other capital claim cash flows ("OCCCF").

### Dividend Discounted Cash Flow Method

With the dividend discounted cash flow model, the value of equity is equal to the present value of dividends paid to common shareholders. Expected dividends are forecasted and discounted back to present value as of the valuation date using the cost of equity capital. The only cash flows considered in the dividend discount model are the cash dividends to common equity, where

**( 3 )** CE = DIVIDENDS

### Equity Discounted Cash Flow Method

In the equity discounted cash flow method, the value of common equity is equal to the value of the free cash flows to equity, discounted to present value at the cost of equity capital. Equity free cash flow is measured as the cash flow remaining after all cash flows have been paid to, or received from, other claims, rather than the stream of dividends per se. The calculation of equity free cash flow can therefore be expressed as:

**( 4 )** EFCF = FFCF + NOACF – DEBT SERVICE – OCCCF

The value of CE is then equal to the present value of EFCF shown in Equation 4. However, unlike the WACC and Adjusted Present Value methods discussed below, the equity discounted cash flow method requires that the proportion of the firm financed with non-equity claims and amount of payments to each be known each year, the former to calculate the cost of equity, the latter to calculate EFCF. While this may make the exercise superfluous since given this information the value of the firm is already known, analysis of equity free cash flow can provide insights regarding the viability of capital strategies, ability to pay dividends, firm capital requirements and equity risk.

### Adjusted Present Value Method

An important inference from the economic balance sheet is that the value of a firm is equal to the value of its unlevered assets plus the value created from financing. In this respect, the adjusted present value method ("APV") is useful in highlighting the value created by financial leverage. The value of a firm's unlevered assets is equal to the FFCF produced by its CBO, discounted to present value at its unlevered cost of equity capital. The value created from financing is equal to the expected interest tax shields ("ITS"), discounted to present value at the cost of debt if the risk is that the firm may not produce income sufficient to realize the benefits, or at the unlevered cost of equity presuming a constant target capital structure, in which case the risk is that the amount of debt and associated ITS will vary with the value of the firm. The values of non-operating assets, debt and other capital claims, estimated separately by means of appraisal, observed market prices and or cash flow models, are then added or subtracted to calculate CE as illustrated in Equation 5.

**( 5 )** CE = ( FFCF + ITS ) + NOA – DEBT – OCC

### Weighted Average Cost of Capital Method

Like the APV method, the value of a firm's unlevered assets using the weighted average cost of capital method ('WACC") is equal to the FFCF produced by its CBO, discounted to present value. In contrast to the APV method, however, the WACC method calculates the present value

of the unlevered assets and interest tax shields together by adjusting the discount rate for the interest tax shield. The result is the WACC, which will be lower than the unlevered cost of equity capital if interest tax shields create value. If so, the value of CBO will also be higher. The values of non-operating assets, debt and other capital claims (estimated separately as with APV) are subsequently added or subtracted to the present value of FFCF to calculate CE as shown in Equation 6.

**( 6 )** CE = FFCF + NOA – DEBT – OCC

**Residual Income Method**

The residual income method differs from others in that accounting earnings and the book value of total invested capital are used in place of free cash flow and cash investment. If correctly executed, however, the residual income method yields the same value as the DCF method given that it adjusts for accrual accounting related timing differences between a firm's earnings and free cash flows over the life of the firm. As implemented, residual, or excess income ("RI") is equal to projected CBO accounting earnings minus the required return on CBO. The required return on CBO is equal to the product of the cost of capital and the book value of CBO at the beginning of the period. To calculate the value of CBO, the book value of CBO ("BVCBO") as of the valuation date is added to the present value of the expected residual income ("RI") over the forecast period. The value of CBO is then adjusted by adding or subtracting the separately estimated values of NOA, DEBT and OCC to calculate CE per Equation 7.

**( 7 )** CE = ( BVCBO + RI ) + NOA – DEBT – OCC

## Summary

An economic balance sheet differs from a GAAP balance sheet in that it is prepared using market values, items included are classified as operating, non-operating, debt or equity-related, and it includes economic assets and liabilities. The total of DEBT, OCC and CE is equal to the sum of CBO and NOA. CBO and NOA generate cash inflows for the firm, while DEBT, OCC and CE result in cash outflows. Applying these relationships to valuation depends on the method. Each will result in the same value given identical assumptions. The dividend discounted cash flow model discounts expected dividends. The equity discounted cash flow method discounts cash flow remaining after all other claims are satisfied. The APV, WACC and Residual Income methods share that the values of NOA, DEBT and OCC are measured separately by means of appraisal, observed prices or cash flow models, while CBO are valued by forecasting and discounting the related cash flow streams. They differ in that (1) the APV method discounts forecasted FFCF at the unlevered cost of equity and adjusts the result for the value created from financing; (2) the WACC method discounts forecasted FFCF at the WACC; and (3) the Residual Income method restates free cash flow in terms of RI and adds the discounted value of RI to the book value of CBO.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