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Business In Crisis: Week One

Scott D. Smith, CIRA, CTP
HYDRA Professionals LLC

When a business "hits the wall" (i.e., is unable to continue operations due to lack of funding), all stakeholders become engaged in a process distinctly different from past practices. Whether a stakeholder is an officer of the company, a creditor, a supplier or a customer, companies in crisis require special attention and immediate actions.

Ownership and management are now in a position where they must face reality, address issues either previously unknown or ignored, and allow "outsiders" to have access to information and become involved in their decision making process. The activities and actions needed when an organization hits the wall typically require entirely different skills than those present in the existing organization. Ownership, management or outside constituents should seek help from turnaround specialists and legal counsel, with distressed business experience, to help them through the crisis. These specialists will provide critical leadership in developing an objective understanding of the current situation, stabilizing the company through a process aimed at managing stakeholder interests fairly, and developing a long term plan encompassing the interests, positions and needs of all constituents.

At the point when a company becomes unable to continue operations and a turnaround specialist is appointed along with legal counsel, an appropriate action plan must be adopted quickly. The first week of a turnaround is typically focused in the following three areas:

1. Short-term Survival and Mitigation of Value Loss

2. Developing a Broad Understanding of Various Stakeholders' Interests, Demands and Potential Actions

3. Implementing Processes to Control and Manage Critical Activities

Short-term Survival and Mitigation of Value Loss
Activities to ensure short-term survival while mitigating loss of value include:

- Obtaining a detailed understanding of the current cash position and near-term viability of the company

- Determining the borrowing base availability or out-of-formula position, and

- Conducting an assessment of the present ability to deliver goods or services to customers and the related constraints including cash requirements

These activities should provide an understanding of what is required to re-establish the revenue generating capability of the business. Often, the cash crisis is immediate (i.e., the business cannot pay its employees or critical suppliers) and the existing equity holders cannot or will not provide any additional funding. If this is the case, to avoid shutting down production, the customer(s) and the lender(s) will have to work cooperatively to bridge the immediate liquidity gap. Once the immediate funding needs are addressed, short-term financial accommodations from the stakeholders including customer(s), lender(s), and suppliers should be pursued and captured in a formal agreement among the parties. For example, requests may include: accelerated payment terms from customers, extended payment terms to suppliers, additional equity from the owners, or a temporary over-advance from a lender. Generally it is in the best interest of one or more stakeholders to support the company in the short-term until the problems are understood and alternative strategies can be developed.

Furthermore, assessments should be made to determine the liquidation value of the enterprise. What are the collectable accounts receivable, usable inventory and appraised value of the fixed assets? What is the security position of the secured creditors and the extent of credit provided by suppliers and other unsecured creditors? The preliminary answers to these questions provide a baseline to establish current value as well as guidance in managing stakeholders and mitigating further loss.

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Peter Stenger - Editor
Baxter Dunaway - Section Editor
Jack Williams - Scholar in Residence
Forrest Lewis - Section Editor
Miles Stover - Section Editor
Stacey Schacter - Section Editor
Jennifer Ginzinger - General Editor

AIRA's Scholar in Residence

Professor Jack F. Williams, CIRA/CDBV
Georgia State University

BANKRUPTCY RETAKES

Ethics: Part II

In my last column, I focused my comments on ethics in the restructuring profession. Specifically, I discussed the core elements of competence and due care. In this column I plan to do much the same, drawing from our own Code of Professional Ethics (Code) and any other body of ethics that may regulate any other professional certification one may possess. Recall that you may find our Code on the AIRA website and in the front of our directory. Now, I will address the remaining core elements: confidentiality, integrity, and objectivity.

Our core element of confidentiality requires that we not disclose confidential information acquired in the course of our work unless authorized (client permits you to disclose) or legally obligated to do so (by court order, including a subpoena). This duty further requires that we teach those we supervise of the importance of this core element and that we monitor their performance. Additionally, we are to refrain from using or appearing to use confidential information for unethical or illegal advantage. This duty may present itself in rather odd situations. For example, recently an AIRA member was being deposed in Case 2 about several financial issues. During the deposition, the examining attorney inquired about the AIRA member's involvement in Case 1, a prior engagement for a different client involving some of the same forensic techniques. The examining attorney then sought financial information and a confidential report related to Case 1 and only indirectly related at best to the actual case. The AIRA member, consistent with his understanding of the ethic of confidentiality, contacted the prior client and its attorneys about the pending request rather than disclose the information. Ultimately, the attorney abandoned his request.

The second core element is integrity. At its epicenter is a duty of honesty and candor, tempered by the element of confidentiality. A component of honesty is to avoid conflicts and to disclose to the relevant parties any potential conflicts. Honesty means to tell the truth, the whole truth, and nothing but the truth – all within the constraints of client confidentiality. There is no room for knowingly misrepresenting facts. The element of integrity also requires that we not engage in or support any activity that would discredit the profession.

The final core element is objectivity. This element requires that we are impartial, intellectually honest, and free of conflicts of interest. Under this element, we are required to communicate information fairly and objectively.

Considering both Parts I and II of the Ethics column, one can appreciate the rigorous standards our organization imposes on us. These five core elements provide an elegant matrix of ethical responsibilities that form the watchwords of our profession. In our engagements, we should be forever mindful of these requirements and never lose sight of the fact that we owe these duties not only to the profession, but to ourselves. ■

Letter from the President

Grant T. Stein
Alston & Bird LLP

In my column at the end of 2009 I wrote about the comments of Thomas R. Keene of Bloomberg, who spoke at the National Conference of Bankruptcy Judges at the end of October. He told the audience that GDP numbers were about to be issued that would reflect a boom economy in which unemployment would remain at a high level. He described this *structural unemployment* and indicated that notwithstanding strengthening in the economy, there would be a permanent and higher level of unemployment.

Mr. Keene appears to have been accurate in his views. The Department of Labor reported that in February and March, 2010, unemployment remained high at 9.7% or 15.0 million persons, which was only slightly lower than the 10% levels in October through December, 2009. The rate was highest among blacks and Hispanics, at 16.5% and 12.6% respectively. http://www.bls.gov/news.release/pdf/empsit.pdf. Significantly, as Mr. Keene had indicated would occur, revised statistics showed that U.S. gross domestic product rose 5.9% at a seasonally adjusted annual rate in the fourth quarter of 2009.

During March, 2010, various Wall Street Journal reports have indicated that U.S. consumer spending rose 0.3% in February even though personal income did not improve, while inflation stayed benign. In January, the U.S. trade deficit narrowed to $37.29 billion with the Commerce Department reporting a 1.7% decline in imports and a 0.3% drop in exports as the volume of oil imports hit its lowest level in more than a decade. Current oil price increases indicate a growing demand for oil reflecting increased economic activity. This 5.9% level of growth of GDP noted above was said to have accelerated to the strongest pace in more than six years in late 2009 as businesses slowed inventory reduction and boosted spending even though consumers spent less than initially believed. Of course, the continued rebound of the Dow Jones Averages to around 11,000 indicates a core improvement in investor confidence in business performance.

Does this mean that the growth in our mid-market restructuring practices has declined since the mega-cases have slowed? It appears that the answer is dependant on the industry at issue. Anecdotally, there continues to be an active restructuring practice in many industries around the country. There was a reported slowdown in the fourth quarter and first quarter, but as financial institutions deal with reporting requirements, the pressure for resolution of defaulted debts appears to be on the rise as the desire to clear out unperforming loans increases.

The foregoing discussion does not even mention the changes that are occurring with the passage of health care legislation.

In summary, economic stresses have not abated yet, though as Mr. Keene indicated, the economy is stronger.

Where will this leave us as restructuring professionals? The AIRA's 26th Annual Bankruptcy & Restructuring Conference to be held June 9-12, 2010, in beautiful San Diego, will answer many of these questions. Our keynote speakers, former U.S. Senator William H. Frist, Roger Grabowski of Duff & Phelps, Fred Crawford of AlixPartners, Professor Valery Ramey, PhD. Economics Professor at the University of California, San Diego, and Professor Jack F. Williams of Georgia State University, BDO Consulting, and the AIRA's Scholar in Residence, along with the other programs and panelists in San Diego, will help us explore and understand the significant changes and opportunities we are facing. We look forward to seeing you in June. ■

Grant T. Stein

Grant Stein is a partner in Alston & Bird's Bankruptcy, Reorganization and Workouts Group. His diverse practice includes the representation of debtors, secured and unsecured creditors, creditors' committees, and fiduciaries in complex and difficult out-of-court workouts, debt restructurings, bankruptcy cases, and financial transactions throughout the United States and internationally. He also regularly represents officers, directors, and other parties in bankruptcy litigation of all kinds. His restructuring experience includes manufacturing, real estate, wholesale, retail, distribution companies, health care, communications, technology and intellectual property issues.

Goods Received Within 20 Days—Section 503(b)(9) Issues and Impacts

Grant Newton, CIRA
AIRA Executive Director

The 2005 Act added section 503(b)(9) giving an administrative expense claim to a creditor that delivers goods to a debtor within 20 days prior to filing of the debtor's petition. The administrative expense claim for goods delivered within 20 days is referred to as a "Section 503(b)(9) claim." Among the business changes to the Code made by the 2005 Bankruptcy Act, section 503(b)(9) may be having the greatest impact on chapter 11 reorganizations. Trustees and debtors have considered new preplanning issues and implemented systems to manage 503(b)(9) requests. There has been extensive litigation on the meaning and application of section 503(b)(9). The right of a creditor to receive payment of a 503(b)(9) claim which is subject to pending reclamation has been challenged under 502(d). Additionally, creditors' requests for 503(b)(9) administrative expense treatment of amounts used to offset preference actions are facing challenge, and some feel preference actions have increased due to 503(b)(9).

Provisions of Section 503 (b)(9)

As modified by the 2005 Act, section 503(b)(9) reads as follows:

> (b) After notice and a hearing, there shall be allowed administrative expenses, other than claims allowed under section 502(f) of this title including—
>
> . . .
>
> *(9) the value of any goods received by the debtor within 20 days before the date of commencement of a case under this title in which the goods have been sold to the debtor in the ordinary course of such debtor's business.*

It is generally agreed that the intent of this provision is to increase protection of suppliers to debtors in distress; there are some who feel legislative history suggests it was conceived to aid sellers who do not file timely claims for reclamation. Under section 546 creditors of troubled businesses are allowed to seek reclamation of goods delivered to a debtor within a stated number of days (currently 45) prior to the debtor's petition date. However, in many cases inventory is pledged in an asset-based financing agreement, which means a prior perfected lien exists on such goods. This generally renders the right of reclamation moot, leaving no or limited recourse through reclamation. Furthermore, even where a lien does not moot reclamation, many vendors' reclamation requests are disallowed due to failure to submit timely written notice.

Section 503(b)(9) acts to encourage suppliers of troubled operations by providing the avenue of administrative expense claims to seek payment for goods received by a debtor during the 20 days prior to the petition. However, 503(b)(9) administrative expense treatment for "20-day goods" combines with two other changes by the 2005 Act to substantially increase the burden for debtors trying to reorganize. These other two changes are in amendments to section 546:

1. increasing to 45 days (previously 10 days) the period during which goods received by the debtor prior to petition filing are subject to reclamation; and
2. changing the time period for submission of reclamation requests to 20 days after the petition has been filed (instead of the previously allowed 20 days after delivery of the goods).

The right to reclamation provided in section 546 as it existed prior to the 2005 Act already had the potential to seriously limit a debtor-in-possession's ability to operate in some situations. Extending the pre-petition qualifying period and the period for filing reclamation claims increases the potential for reclamation. However, 503(b)(9) adds more weight to the suppliers' side of the equation because 20-day goods are not encumbered by some limits on reclamation—priority is not lost when goods are no longer in the debtor's possession or are unidentifiable—and stepping them up to administrative priority improves their position compared to general unsecured claims.

Impact on Relations with Trade Creditors

These provisions have potential to increase impairment of a significant source of financing for the chapter 11 plan—trade credit. Historically, debtors have often filed chapter 11 petitions with arrangements for new goods to be shipped under administrative expense priority. Unsecured claims of suppliers outstanding as of the date of filing were frequently paid with an equity position in the debtor or with long term notes, often at a small percent of the total claims. Section 503(b)(9) claims appear to deem as "critical" all vendors delivering goods within 20 days of the petition date. In addition, section 546(c)(2) as amended even provides that if a seller of goods fails to provide notice in the manner described in paragraph (1), the seller still may assert a section 503(b)(9) claim for administrative expense. To some extent section 503(b)(9) codified the practice of allowing critical vendors' prepetition claims to be paid once the chapter 11 petition was filed.

In today's just-in-time environment, delivery schedules in automotive and other industries generate large numbers and dollar values for goods delivered during the 20-day period. The result is that a very substantial amount of prepetition trade debt has received a priority promotion with the apparent likelihood of larger and faster payment of claims. The enormous complexity and cost to debtors of dealing with such claims while trying to confirm a plan have prompted intensive efforts to challenge the validity and timing of 503(b)(9) claims; e.g., in Plastech Engineering (attempting to disallow administrative status to 503(b)(9) claims), Circuit City and Commissary Operations (attempting to deny set-off of 503(b)(9) invoices against preference claims, among others (see discussion below). However, it should be realized that with just-in-time, many suppliers *must* be paid: they to do not have resources to fund the restructuring of the debtor. Thus, the impact of 503(b)(9) may be minimal because suppliers must be paid anyway in order to continue the supply of goods to the debtor.

Dealing with 503(b)(9) Claims

As described above, the combination of section 503(b)(9) and the reclamation changes tend to improve the position of suppliers, and has "upped the ante" in the struggle to reorganize and successfully exit from chapter 11. Over the last four years, trustees, debtors in possession and creditors have developed awareness of potential impacts of and strategies to optimize their positions, including preplanning measures, use of bar dates and litigation.

Preplanning

In situations where the debtor does not have the ability to pay the 503(b)(9) claims it is critical that the debtor not order any goods (or limited goods) for product lines or stores that will be shut down at, or immediately after, the filing of the petition. This creates a need for additional planning on the part of the debtor and its financial advisors in order to avoid unnecessary administrative expenses. Thus, the financial advisor along with counsel needs to work with the debtor to determine the potential section 503(b)(9) claims and develop an overall strategy for dealing with them.

Use of Bar Dates

A significant issue considered in preplanning is whether the bar date for 503(b)(9) claims should be established prior to the general bar date or included with the general bar date. Stickles and Dean identify some of the advantages and problems of using an earlier bar date.[1] For example, if an earlier bar date is used it may result in a large number of claims regardless of the nature of the claims.

Creditors that are notified of a bar date for section 503(b)(9) claims must file a timely proof of claim—failure to do so may result in disallowance of the administrative expense status or of the entire claim. For example, in the Dana bankruptcy case a creditor filed a $1.4 million section 503(b)(9) claim more than six months after the bar date. The court ruled the creditor was not entitled to an enlargement of time, because evidence showed the debtors' noticing agent had mailed copies of the court's order establishing the bar date to the creditor at several addresses, and those notices were not returned by the U.S. Postal Service as undeliverable.[2]

Increased Litigation

A number of 503(b)(9) disputes and issues have been broached in the courts to test various aspects of the meaning of the provision. Among the issues addressed by the courts is the definition of "goods," "received by the debtor," and "sold to the debtor in the ordinary course" (see "Applicability of Section 503(b)(9)" below). There has also been a tendency by some to use a blanket approach to preference action, for example, to try to quickly activate as many options as possible and sort it out later.

The bankruptcy court noted, in discussing a trustee's report, that it was troubled by a trend in large bankruptcy cases of engaging in preference litigation with reckless abandon. Finding the trustee's preliminary report to be thorough, thoughtful, and helpful, the court accepted the report; however, it ordered the trustee not to sue any of the parties identified in the report. The court also ordered the trustee not to sue any vendor in respect to payment made for goods shipped in the 20-day period before the petition date, which, if unpaid, would have given rise to a section 503(b)(9) claim.[3]

Timing of 503(b)(9) Payments

An issue not addressed in the statute is, when the section 503(b)(9) administrative expenses are to be paid. Where a claimant timely files a request for payment of an administrative expense the timing of payment is left to the discretion of the court, which considers the policy goal of orderly and equitable distribution among creditors and protection of the debtor's assets. In two cases, *In re Global Home Products LLC.*[4] and *In re Bookbinders' Restaurant Inc.*,[5] courts have concluded claimholders have no special right to immediate payment for 503(b)(9) claims. In both cases the court examined three issues: (1) the prejudice of the debtor, (2) the hardship on the holder of the administrative expense, and (3) the potential detriment to other parties.

In *Global,* the DIP argued that requiring immediate payment of section 503(b)(9) claims would expose the debtor to financial risk by adversely affecting the DIP's borrowing availability; the aggregate section 503(b)(9) claims far exceeded the company's ability to borrow. The creditor argued it would be a hardship and inequitable to delay payment in light of the administrative expense priority under 503(b)(9). The court found that the creditor would "suffer little prejudice or hardship if payment" if its allowed administrative claim was deferred until after confirmation, but that the Debtors would "suffer a substantial hardship" if immediate payment were allowed.[6]

In *Bookbinders,* [7] the creditor argued it was entitled to immediate payment as a matter of law and because the debtor had been paying other administrative expenses, specifically postpetition trade debt. The court concluded that preconfirmation allowance of a section 503(b)(9) administrative expense does not create an "unqualified right to immediate payment." The court noted the timing of payment of a 503(b)(9) administrative expense is governed by the same principles that govern payment of other administrative expenses and during a chapter 11 case, the debtor may pay expenses in the ordinary course without notice and a hearing under 11 U.S.C. §363(c)(1); thus postpetition trade debt may be paid before prepetition trade debt. The court also pointed out that under section 1129(a)(9)(A) full payment of administrative expenses is required on the effective date as a condition of confirmation unless the holder agrees to different treatment. In his Discussion, Judge Frank mentions four points in the life of a chapter 11 case when 503(b)(9) 20-day expenses may be paid:

[1] J. Kate Stickles and G. David Dean, "A Roadmap for Managing §503(b)(9) Claims and Objections: The Debtor's Perspective", 27-8 ABIJ 26.

[2] In re Dana Corp., 2007 Bankr. LEXIS 1934 (Bankr. S.D.N.Y. May 30, 2007).

[3] In re Brook Mays Music Co., 2007 Bankr. LEXIS 2902 (Bankr. N.D. Tex. Aug. 1, 2007)

[4] In re Global Home Products LLC, 2006 Bankr. LEXIS 3608 (B.D. Delaware, Dec. 21, 2006).

[5] In re Bookbinders' Restaurant, Inc., (Bankr. E.D. Penn., Dec. 23, 2006).

[6] *Supra,* fn. 4.

[7] *Supra,* fn. 5.

1. immediately upon commencement of the case

2. immediately upon allowance

3. prior to confirmation, in the discretion of the debtor

4. on the effective date of the plan, along with other administrative expenses.

Applicability of 503(b)(9)

It is important to keep in mind that secured goods delivered within 20 days prior to filing do not have the same benefit under section 503(b)(9) and are not entitled to administrative expense status.[8]

The 503(b)(9) claims provision is limited to goods; thus personal property not considered goods is not subject to administrative expense status.[9] Issues may arise as to characterization of goods, as illustrated by a claimant's argument that under Articles 2 and 9 of the UCC that electricity is a good because it is "movable" and qualifies for administrative expense status under 503(b)(9). The bankruptcy court rejected this argument, holding that electricity is more properly categorized as a service and therefore §503(b)(9) does not apply.[10]

Administrative expense is allowed under section 503(b)(9) when the debtor had actually received the goods, not just their value. The bankruptcy court in *In re Plastech Engineered Prods.* determined that whether the debtor itself needed to take actual physical possession of the goods, or whether the debtor could be found to have received the goods when a third party took possession, was an issue that could only be resolved after a full evidentiary record had been developed. The record had not been sufficiently developed to enable the court to determine whether or not the third party took actual physical possession of the goods as an agent, designee, bailee, or in some other representative capacity for the debtor.[11]

A case involving the timing of the receipt of a vehicle in order to determine approval as an administrative expense illustrates continuing issues about designating 503(b)(9) "20-day" goods as administrative expenses. The creditor argued the transaction occurred after the debtor filed its petition and thus was an administrative expense under section 503(b)(1) as beneficial to the debtor's business. The debtor argued that section 503(b)(1) did not apply because the swap occurred prior to the debtor's bankruptcy. The bankruptcy court held that the insurer was entitled to an administrative expense claim regardless of whether the transaction occurred prepetition or postpetition.[12]

In order to qualify for 503(b)(9) treatment as an administrative expense claim, the goods must have been sold on account and not prepaid.[13]

Section 503(b)(9) and Preference Actions

Another significant issue in the tug-of-war among the parties to 503(b)(9) disputes is whether pending amounts of 503(b)(9) administrative expense claims by creditors can also be granted 547(c)(7) new value exemption from recovery of preferential payments. An excellent presentation of the issues is found in *Commissary Operations.*

Commissary Operations

In a Memorandum Opinion filed in the case of *Commissary Operations*,[14] Judge Harrison sets out a detailed consideration of the issue of setting off amounts of invoices subject to pending 503(b)(9) claims against claims against suppliers for preferential payments.

The debtor's primary business involved wholesale distribution of food and related products to chain restaurants and franchises. The debtor filed a chapter 11 petition on July 22, 2008, intending to reorganize but ultimately deciding to liquidate. Over 200 creditors filed for section 503(b)(9) administrative expense treatment for invoices for goods delivered within 20 days prior to the petition. The debtor filed adversary proceedings against a number of creditors to recover alleged preferential payments by the debtor within 90 days of the petition. A group of creditors took the position that their liability for preferences could be reduced for new value provided to the debtor within the 20 days, even if a 503(b)(9) administrative expense claim was filed for invoices related to the new value. On January 6, 2010, the Court ruled in favor of the defendant creditors.

The plaintiff debtor in *Commissary Operations* asserted that allowing the new value provision to negate preference liability for payments that might also receive administrative expense status unfairly grants a double benefit to "20-day" creditors over other creditors. The defendant creditors argued that goods delivered to a debtor within 20 days prior to the petition benefit the debtor and the estate and should not be excluded from the 547(c)(7) new value exemption. Support for the creditors' position include:

- Claims for administrative expense payment for goods delivered within 20 days prior to a petition can only arise after the petition is filed.

- The 20-day provision only affords the creditor the right to request administrative expenses status, not to seek reclamation or encumbrance of the goods delivered.

- 503(b)(9) claim payments to creditors by definition can only occur postpetition, and since postpetition payments cannot be used to deplete prepetition value, they cannot be used to deplete the amount used in a creditor's new value defense against preference action

- Allowing the new value exemption furthers the policy of encouraging creditors to do business with troubled debtors.

The Court points out that the assertion of a 503(b)(9) claim only means the creditor is entitled to the priority of administrative expense for its request for payment. Payment is dependent

[8] In re Brown & Cole Stores LLC., 375 B.R. 873, 879 (9th Cir. BAP, 2007).

[9] In re Deer, Case No. 06-02460-NPO (Bankr. S.D. Miss., June 14, 2007)(citing L. King, 4 *Colliers on Bankruptcy*, ¶503.16[1] (15th ed. rev. 2005))(advertising purchased under contract does not constitute sale of goods under 11 U.S.C. §503(b)(9)).

[10] In re Samaritan Alliance LLC, 2008 Bankr. LEXIS 1830 (Bankr. E.D. Ky. June 20, 2008). For additional analysis of recent cases, see J. Kate Stickles and G. David Dean, "A Roadmap for Managing §503(b)(9) Claims and Objections: The Debtor's Perspective", 27-8 ABIJ 26 and David B. Wheeler, "20-Day Sales Claims under §503(b)(9): Finding Your Way Through Uncharted Territory", 27-9 ABIJ 16.

[11] In re Plastech Engineered Products, Inc., 2008 Bankr. LEXIS 3130 (Bankr. E.D. Mich. Oct. 7, 2008).

[12] In re Rio Valley Motors Co., LLC, 2008 Bankr. LEXIS 959 (Bankr. D.N.M. Mar. 24, 2008).

[13] In re Wetco Rest. Group, LLC, 2008 Bankr. LEXIS 1272 (Bankr. W.D. La. Apr. 23, 2008).

[14] In re Commissary Operations, Inc 421 B.R. 873 (Bankr. M.D. Tenn. Jan 26, 2010).

upon approval of the request by the Court and ability of the debtor to pay the claim either before or after plan confirmation (see "Timing of 503(b)(9) Payments" above).

Furthermore, the Court emphasizes that the right of a creditor to file an administrative expense claim is not related to the right to reclamation. Section 546(c)(2) was amended by 2005 Act to provide that "if a seller fails to give notice in the manner described in paragraph (1) [regarding reclamation], the seller may still assert the rights contained in section 503(b)(9) [regarding administrative payment]." This amendment, plus the fact that 503(b)(9) does not allow a 20-day creditor a lien for or reclamation of such goods, enforces the differentiation of a creditor's right to administrative expense claim from its right of reclamation. With reclamation claims, the debtor must segregate and return the goods, depriving it of the ability to use the goods to sustain continuing operations. By allowing creditors the possibility of administrative expense claims while freeing debtors to use goods before or after the petition date without any strings attached, the provisions of 503(b)(9) support Congress' policy goals in preserving creditor willingness and debtor ability to continue operations. The application of the new value principle has impacts consistent with this policy. The Court reasons that forcing creditors to try to choose between protection of administrative status and new value exemption would tend to work against congressional intent.

Judge Harrison makes a clear statement of the new value argument in general, pointing out that receipt of goods prepetition allows the debtor to resell the goods at a profit or incorporate them into manufactured products for sale even as financial condition falters. The debtor thereby benefits from value of goods received even as it contemplates bankruptcy, but many of its suppliers are not granted any security or guarantee of payment. For this reason it is held to be consistent with policy goals that creditors delivering goods within the last 20 days before the petition be included in protection offered by Section 547(c)(4), which states a debtor may not avoid a transfer

> to or for the benefit of a creditor, to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor—(A) not secured by an otherwise unavoidable security interest; and (B) on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor.

Section 503(B)(9)—Debtors' Setoff Rights

In an interesting parallel to creditors' setoff of 503(b)(9) claims against preference liabilities, debtors and secured lenders have attempted to setoff a laundry-list of prepetition credits claims agains creditors' 309(b)(9) priority claims. Examples of such credits on the debtors' side include prepetition chargeback, returns, credits, rebates, deductions, allowances and other similar claims. Examples occur in the *Brown & Cole* and *Circuit City* cases.

Brown & Cole

The Ninth Circuit ruled in this case that the debtor could exercise its setoff rights arising from a prepetition breach of contract claim to reduce the creditor's section 503(b)(9) administrative expense claim 20-day claims for over $6.3 million. The court ruled to allow payment of the creditor's 503(b)(9) claim, rejecting Brown & Cole's argument because it was based on a lower priority prepetition unsecured claim. However, on appeal this decision was reversed. The appellate panel noted the 503(b)(9) claim's prepetition origin met the prerequisite for mutuality of the transactions for setoff. The court stated that setoff is an equitable remedy allowing parties that owe money to each other to cancel them out.[15]

Circuit City

In the Circuit City case, in December of 2009 the Bankruptcy Court ordered the closing and liquidation of Circuit City's remaining 567 stores, which was completed in March 2009. After the DIPs had obtained financing secured by inventory and proceeds, per a court order regarding § 546(c) claims, such claims were deemed rejected. The DIPs then abandoned efforts to reorganize. The creditors did not object to liquidation, did not file adversary complaints nor seek relief from stay; they filed claims variously classified as either secured or priority claims per section 546(c) and section 507(a)(2) or as unsecured claims. In October, Circuit City filed objections to a significant number of 503(b)(9) claims on the basis that section 546(c) provided no basis for a demand that creditors be given an administrative expense or secured lien status. Thus, the creditors were not entitled to administrative expense under section 503(b)(9). Furthermore, the DIP filed action to reduce the creditor claims by their own prepetition claims against the creditors, including chargebacks, returns, credits, rebates, deductions, allowances and others. Although the creditors had other nonpriority general unsecured claims, the debtor sought to apply the setoff to the administrative expense claims, invoking setoff rights under Virginia state law and arguing the existence of the necessary mutuality. The Court ruled in favor of the debtor, finding that the requisite mutuality existed and relying on section 558 which preserves debtors' setoff rights among others. The Court also concluded this would further the policy goal of maximizing distribution to all creditors. [16]

Sec. 503(b)(9) and Sec. 546(c)(2)

Prior to the 2005 Act Section 546(c)(2) provided that "the court may deny reclamation to a seller with such a right of reclamation that has made such a demand only if the court A) grants the claim of such a seller priority as a claim of a kind specified [administrative expense] in section 503(b) of this title; or (B) secures such claim by a lien." In Circuit City[17] after the DIPs obtained financing secured by inventory and proceeds and per a court order regarding § 546(c) claims, such claims were deemed rejected. The DIPs then abandoned efforts to reorganize. The impacted creditors did not object to liquidation, file adversary complaints or seek relief from stay. Instead, they filed claims variously classified as either secured or priority claims per section 546(c) and section 507(a)(2) or as unsecured claims. The DIPs objected on the grounds that section 546(c) provided no basis for a demand that creditors be given an administrative expense or secured lien status, thus creditors were not entitled to administrative expense under section 503(b)(9). The bankruptcy court granted the debtor's motion, stating:

[15] In re Brown and Cole Stores, LLC. 375 B.R. 873 (9th Cir BAP, 2007).

[16] In re Circuit City Stores, Inc., 2010 Bankr. LEXIS 697, 18-31 (Bankr. E.D. Va. Mar. 4, 2010)

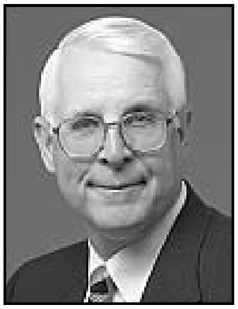
[17] Ibid.

In making these changes to Bankruptcy Code § 546(c), Congress appears to have limited a reclamation seller's right to an administrative expense claim to that provided under Bankruptcy Code section 503(b)(9). The Fourth Circuit[18] noted that when words were deleted from the Bankruptcy Code, the Court 'must presume that Congress intended what it said when it . . . delete[d] the words.' The Reclamation Claims asserted by the Respondents are simply not entitled to an administrative expense priority beyond that to which they may be entitled under Bankruptcy Code section 503(b)(9).

In a similar decision in In re First Magnus Fin. Corp.[19] the bankruptcy court noted the statute does not give such a seller/creditor an administrative claim, except to the extent it qualifies for one under § 503(b)(9). ■

[18] In re Equipment Services, Inc., 290 F.3d 739, 745 (4th Cir. 2002).

[19] 2008 Bankr. LEXIS 4320 (Bankr. D. Ariz. Oct. 16, 2008).



Taxation Cases

Forrest Lewis
Plante & Moran PLLC

INDIVIDUAL BANKRUPTCY:

IRS DISCUSSES TAXES NOT DISCHARGEABLE IN CH. 13

In a recent Chief Counsel's Advice, the Internal Revenue Service explained its view of what taxes, penalties and interest are not dischargeable in a Chapter 13, so called "wage earner" bankruptcy, CCA 201005029. Chapter 13 is different than Chapters 7 or 11 in several respects. First, a confirmed wage earner's plan will require the individual to make certain monthly payments on their debts for three to five years. Also, the debt discharge is effective at the end of the payment period, not at the beginning of the proceeding when the plan is confirmed.

Significant changes were made to the Bankruptcy Code by the Bankruptcy Abuse and Consumer Protection Act of 2005 (BAPCPA). Two of the major motivations behind BAPCPA were to reduce the number of individual Chapter 7 liquidation cases and funnel more individual debtors into Chapter 13 to require some attempt to repay debts and to protect federal government revenues by reducing the scope of dischargeable federal tax claims. Most of the changes were effective for bankruptcy cases filed on or after October 17, 2005. The ruling explains the IRS view on whether a variety of federal tax debts are no longer collectible when a taxpayer successfully completed a Chapter 13 plan in a post-BAPCPA case receiving a general discharge and those tax claims that are not dischargeable. Prior to BAPCPA, a Chapter 13 debtor who completed his plan payments was entitled to what has been referred to as a "super discharge" of all taxes provided for by the plan or disallowed under section 502, including taxes stemming from fraudulent or unfiled returns. BAPCPA substantially narrowed the scope of the Chapter 13 discharge by excepting from the discharge a number of tax debts. B.C. § 1328(a) lists the debts excepted from the general discharge.

1. For bankruptcy cases filed on or after October 17, 2005, these federal tax debts are nondischargeable:

debts for withheld taxes,
taxes for which a return was not filed,
taxes for which a return was late-filed within two years of the bankruptcy case,
taxes for which the debtor filed a fraudulent return, and
taxes that the debtor attempted to evade or defeat

2. In addition to the above list, debts that were neither listed nor scheduled under B.C. § 521(1) [re-designated by BAPCPA as subsection 521(a)(1)] with the name of the creditor to whom the debt is owed in time to permit a proof of claim to be timely filed cannot be discharged, unless the creditor had notice or actual knowledge of the case in time to file a timely proof of claim. This exception applies where the debtor fails to list the Service on its schedule of liabilities or otherwise notify the Service of the bankruptcy case. However, if the Service learns of the bankruptcy proceeding in time to file a timely claim, discharge will apply. This was also true under pre-BAPCPA cases.

3. If the tax debt is dischargeable in Chapter 13, then the associated prepetition and postpetition interest is dischargeable. If the underlying tax liability is not dischargeable, then the associated prepetition and postpetition interest liability is also not dischargeable.

4. All nonpecuniary tax penalties [those which are arbitrary in amount and are not calculated to make the government unit whole for lost revenue] and the interest that accrues thereon are dischargeable.

Interestingly, the IRS ruling takes note of a pre-BAPCPA Ninth Circuit case which held that a plan that was confirmed without objection to a provision purporting to discharge an otherwise nondischargeable claim was binding on the parties. That case did not involve taxes, but a student loan which is generally nondischargeable, thus the terms of the plan made a nondischargeable debt dischargeable. In re Pardee, 193 F.3d 1083 (9th Cir. 1999).

Conclusion: the ruling is helpful in understanding the IRS' position on treatment of federal tax debts in Ch. 13 cases, especially for those taxes, penalties and interest which they concede are dischargeable. Experience indicates that the law in this area will probably evolve as cases are litigated in the post-BAPCPA era. ■

Thanks to Grant Newton, Dennis Bean and Katherine Lewis, attorney, for their help with this article.

SOME "GOING PRIVATE" INVESTIGATION COSTS DEDUCTIBLE

The Internal Revenue Service generally requires that costs in connection with a transaction in which a business is sold, recapitalized or reorganized be capitalized and not deducted but in an unusual 2009 private letter ruling, the IRS permitted deduction of some pre-decision investigation costs which led to a taxable business reorganization. The ruling is remarkable in several respects, not only did it allow an ordinary deduction for legal and financial service costs leading up to a "going private" sale of the company by its shareholders, it also included in those deductible costs amounts which were incurred by the shareholders and the buyer and were reimbursed by the company sold. [Private Letter Ruling 200953014]

In 2003 the IRS implemented Reg. 1.263(a)-5, one of the so called "Indopco" regulations, in which it affirmed its long standing position that most expenses in connection with transactions which constitute the sale or reorganization of a business generally must be capitalized (including Ch. 11 reorganizations which are not at issue here). Those regulations do permit deduction of some costs incurred if they are not "inherently facilitative" of a transaction and if they are incurred before the "bright line" date:

(i) The date on which a letter of intent, exclusivity agreement, or similar written communication (other than a confidentiality agreement) is executed by representatives of the acquirer and the target; or

(ii) The date on which the material terms of the transaction…. (as tentatively agreed to by representatives of the acquirer and the target) are authorized or approved by the taxpayer's board of directors (or committee of the board of directors) or, in the case of a taxpayer that is not a corporation, the date on which the material terms of the transaction (as tentatively agreed to by representatives of the acquirer and the target) are authorized or approved by the appropriate governing officials of the taxpayer. In the case of a transaction that does not require authorization or approval of the taxpayer's board of directors (or appropriate governing officials in the case of a taxpayer that is not a corporation) … the date on which the acquirer and the target execute a binding written contract reflecting the terms of the transaction.

Activities which are "inherently facilitative" include getting an appraisal, structuring the transaction, obtaining regulatory approval, obtaining shareholder approval, etc. These must be capitalized when incurred.

The ruling involved a situation in which a corporation's board of directors resolved "to explore the strategic alternatives available to Company to maintain its competitiveness, including a sale of Company" (Date 1). The Company Board voted to sell Company to the buyer via a taxable merger on the same day the buyer executed the Merger Agreement, Date 2. The ruling permitted deduction of costs incurred before Date 2. Those costs included fees paid to: Financial Advisors, Legal Counsel, Accounting Service Providers, and General Service Providers. (A leveraged stock redemption was used and costs directly connected with the borrowing had to be capitalized and amortized over the life of the loans).

The Company represented to the IRS that ' "going-private" [would] …enhance Company's flexibility in making long-term investment decisions in development, acquisitions and partnerships that would benefit its customers. Company and the Sponsors agreed, based on the various due diligence services provided by the Financial Advisors and by the Sponsors, that this Transaction would raise the Company's growth trajectory, allowing greater long-term product and service development decisions, and accelerate Company's vision for its customers.' This statement probably helped IRS to conclude that even expenses incurred initially by the buyers and reimbursed by the Company could be deducted. Otherwise, IRS generally does not allow a corporation to deduct expenses that benefit the shareholders and not the company itself.

Conclusion: this ruling demonstrates that some pre-decision business transaction expenses can be currently deducted by a business if careful accounting is made, especially with respect to timing and a case can be made that the transaction will enhance the future operations of that business. It would seem that the principles of this ruling would apply as well to other types of business sales, reorganizations and recapitalizations besides "going private" transactions. ■

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

FREMONT GENERAL CASE ILLUSTRATES INTERESTING FINANCIAL, TAX ASPECTS

Fremont General Corporation, a Nevada-based financial services holding company and one of the largest originators of subprime mortgages in the U.S., filed a petition in Chapter 11 on July 8, 2008. The case which is still unfolding as of this writing presents several interesting financial and tax aspects. Among the interesting financial aspects:

- apparently there will be some assets left for distribution to the equity holders which is rare these days
- for some reason the debtor company did not exercise its right to put forth a reorganization plan first (exclusivity) which led to voting creditors being offered five competing plans.

There are two mortgage origination subsidiaries—Fremont General Credit Corporation (FGCC) and the successor to Fremont Investment & Loan (FRC) which file a consolidated tax return with the parent and have huge tax losses but are not in bankruptcy

The Official Creditors Committee plan is a straight liquidation but the other four including the Official Equity Committee's all involve some sort of reorganization and continuation of

Taxation continues from **Page 9**

the business. One asset apparently considered important by at least some of those proposing to reorganize and continue is almost $700 million in tax net operating loss carryforwards which if fully realized would result in $240 million in tax savings. Almost all of the following information was extracted from the Official Equity Committee disclosure statement. Here is the link to the webpage: http://www.kccllc.net/fremontgeneral [No opinion is expressed in this article concerning the relative merits of the competing plans.—FL]

1.Loss carrybacks and IRS audits

The tax history of the company is interesting.

In 2006 the debtor incurred an approximate $460 million tax loss which it carried back to 2004 and received a $160 million refund.

In 2007 the debtor incurred a $1 billion loss which generated a $100 million refund when carried back to 2005 which had had $300 million of taxable income. The $700 million balance of the 2007 loss (which is partly attributable to FGCC and FRC) will be carried forward to 2008 and subsequent years. Of course, those net operating losses will only have value if the company can generate taxable income in the future.

As it routinely does, the IRS immediately paid the refunds above, but commenced audit of the loss years to verify the amount of the loss. In fact, the company has been audited by IRS every year since 2004.

The original IRS claim in bankruptcy was $89 million though it was later amended to $2.7 million (but the IRS reserved all rights—presumably meaning to increase the claim to the original amount). And because this case has everything, as a result of one of the IRS audits, the company agreed to make a change in tax accounting method totaling $100 million in taxable income recognized at $25 million per year for four years starting in 2008. One consideration in any liquidation scenario is that the balance of the $100 million would have to be recognized in the year of liquidation. In this case the risk related to that is diminished because of the net operating loss carryforwards.

2.Limitations on use of tax loss carryforwards under IRC Section 382

Cogress enacted Internal Revenue Code Sec. 382 to prevent trafficking in net operating losses of corporations. In general if there is a greater than 50% change in control, the annual use of any tax net operating loss carryforward is subjected to a limitation which can be thought of as an "amortization" based on the IRS interest rate (known as the AFR) times the fair market value of the company at the time of change. This amortization requirement can greatly reduce or eliminate the present value of the tax net operating loss.

Fortunately there are two different favorable rules or paths which a company in bankruptcy may choose. The default provision is IRC 382(l)(5) in which stock received by "historic creditors" is treated as having been owned before the date of change which helps assure that there will not be a 50% or greater change in control during the relevant measurement period. Thus, the corporation will be able to use its net operating losses in full to offset future taxable income. However, there is a "toll charge" in which interest expense incurred in the last three years on debt converted to stock is disallowed. There is also a very punitive special rule providing that if there is a second change in control within two years, the 382 limit becomes zero, i.e. no net operating loss carryforward is allowed.

The other favorable path for companies in bankruptcy falls under IRC 382(l)(6) and does limit the annual use of the net operating losses to an "amortization" amount. Under that rule a company can elect to calculate its fair market value after any conversion of debt to equity and discharge of indebtedness in the plan. This usually has the favorable result of a much higher company fair market value which increases the "amortized" net operating loss amount each year.

In the Official Equity Committee plan it is proposed to qualify under 382(l)(5) treating stock received by historic creditors as having been pre-existing and avoid a change in control and remaining eligible to immediately use any net operating loss carryforwards, thus avoiding any annual "amortization" limit. The advisers to the Official Equity Committee calculate that there has already been a 34% change in control just due to normal trading in the company's stock, so it is important to proceed carefully. The plan anticipates that any stock issued to the trust preferred debt holders of Fremont will qualify as issued to historic creditors and thus not count toward a change in control. In addition, the plan may require certain amendments to the company's articles of incorporation or bylaws to restrict trading in the company's stock to prevent the fatal second change of ownership mentioned above from occurring.

3.Tax effects of proposed liquidation of subsidiaries into parent

As mentioned earlier, part of the $700 million net operating loss is attributable to the two loan origination subsidiaries, FGCC and FRC, although they apparently still have some net worth. Since they are not in bankruptcy, the favorable 382(l)(5) exception for ownership changes involving historic creditors is not available to them. So, in order to avoid a change of control limitation on the net operating loss carryforwards, the plan proposes to liquidate the two subsidiaries into the debtor/parent on the effective date of the plan. Since they do have positive net worth, the liquidations would qualify as a nontaxable 80% or more subsidiary-into-parent IRC 332 liquidation. This will transfer the net operating loss carryforwards to the debtor/parent and it is contemplated by the plan that the favorable 382(l)(5) will then apply to them, however the disclosure statement says that the authority on that is not clear.

4.Cancellation of debt issues

In this plan there will be a relatively small amount of COD income as most classes of creditors will be paid in full.

The Official Equity Committee plan does say that if the trust preferred debt holders vote for the plan and receive stock, there may be some COD income to the debtor. There is an intercompany liability in FGCC/FRC owed to the debtor parent which will be extinguished without causing COD income if there is a valid Sec. 332 liquidation into the parent. [That would probably not be a problem even if there were no valid taxfree liquidation as the federal consolidated tax return regulations generally "turn off" the Section 108 rules on cancellation of debt. In consolidated returns, the corporation with the receivable recognizes a bad debt deduction and the defaulting borrower recognizes an equal amount of COD income. The two offset each other when consolidated, preserving the symmetry sought by the intercompany transaction consolidated return regulations.]

Conclusion

The Fremont case poses many interesting tax issues—liquidation vs. continuation, which path to take under 382 to preserve the net operating losses, the risk of a second change in control, the uncertainty of the ongoing IRS audits, the threat of the recognition of the remaining balance of the change of accounting method and the effort to protect the net operating loss carryforwards of the two subsidiaries by liquidating them into the parent. It will be enlightening to watch the story play out.

Thanks to Grant Newton and Dennis Bean for their assistance.

FEDERAL DISTRICT COURT HOLDS SUB PAYMENTS NOT SUBJECT TO FICA

In a somewhat surprising decision, a Michigan U.S. District Court recently held that certain severance payments are not wages for FICA taxation purposes, potentially opening the door for employers to file a claim for refund. Citing a U.S. Court of Claims decision – which incidentally was overturned in 2008 by the U.S. Federal Circuit Court–the court in *United States v. Quality Stores, Inc., (W.D. Mich. Feb. 23, 2010)* sided with the employer but did not provide a wholesale exemption from FICA for all severance benefits paid; rather, it narrowly addressed "supplemental unemployment compensation benefits" ("SUB payments"). The court concluded that the Internal Revenue Code implies that SUB payments are not wages for federal income tax purposes, and there is no basis to justify differing interpretations of "wages" for income tax and FICA purposes, therefore, the SUB payments were exempt from FICA taxation.

In general, to be considered SUB payments, benefits must at a minimum be:

1) Paid to an employee pursuant to a "plan" sponsored by the employer;

2) Paid because of the employee's involuntary separation from employment

(whether temporary or permanent); and

3) The direct result of a reduction in force, the discontinuance of a plant or operation, or other similar conditions.

Unless payments meet the above criteria, it is probably unlikely that the IRS will issue a refund. For example, even the *Quality Stores* decision would not extend the FICA exemption to severance benefits paid to an individual based solely on that individual's termination (i.e., not as part of an overall reduction in force) or to payments not made under a "plan". However, in circumstances consistent with the minimum criteria, you might consider performing a more in-depth analysis to determine whether a claim for refund is worth-while. The IRS will probably appeal the decision so those that are interested, stay tuned for more developments.

Thanks to Grant Newton, Dennis Bean and Plante & Moran, PLLC for their assistance.

CIRA

New York, NY

Part 2: May 3-5, 2010

Monterey, CA

Part 1: May 19-21, 2010

Location Map

San Diego, CA

Part 3: June 7-9, 2010

Atlanta, GA

Part 2: June 16-18, 2010

New York, NY

Part 3: June 23-25, 2010

Chicago, IL

Part 1: July 28-30, 2010

Atlanta, GA

Part 3: August 4-6, 2010

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Bankruptcy Cases

Baxter Dunaway

Supreme Court

Are attorneys " debt relief agencies" under 11 U.S.C.A. § 101(12A) when they provide qualifying bankruptcy assistance services? Do § 526(a)(4), requiring attorneys to make certain disclosures in their advertisements, and § 528(a) and (b)(2) violate the First Amendment rights of attorneys?

In an eagerly awaited opinion, the Supreme Court unanimously upheld the key features of Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) aimed at attorneys representing debtors in consumer cases. *Milavetz, Gallop & Milavetz, P.A. v. U.S.*, — S.Ct. —, 2010 WL 757616 (U.S. Mar 08, 2010) (NO. 08-1119, 08-1225).

Law firm that practiced bankruptcy law, firm's president, attorney who worked for firm, and two of firm's clients brought suit against the United States, seeking a declaratory judgment that certain provisions of the Bankruptcy Code added by the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) did not apply to attorneys and law firms and were unconstitutional as applied to attorneys.

The Supreme Court held that:
(1) Attorneys who provide bankruptcy assistance to assisted persons are "debt relief agencies" within the meaning of the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA).

(2) Section 11 U.S.C.A. § 526(a)(4) of the Bankruptcy Code added by the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) which provides that a debt relief agency shall not advise an assisted person to incur more debt in contemplation of such person filing for bankruptcy prohibits a debt relief agency only from advising a debtor to incur more debt because the debtor is filing for bankruptcy, rather than for a valid purpose. That is, it prohibits a debt relief agency from advising a debtor to manipulate the protections of the bankruptcy system by "loading up" on debt with the expectation of obtaining its discharge, conduct that is abusive per se.

(3) Bankruptcy Code's 11 U.S.C.A. § 528(a)(4), (b)(2)(B) advertising disclosure requirements applicable to debt relief agencies, which require, inter alia, that such agencies make the following statement, or something substantially similar to it, "We are a debt relief agency. We help people file for bankruptcy relief under the Bankruptcy Code," are reasonably related to the government's interest in preventing deception of consumers. The required disclosures are intended to combat the problem of inherently misleading commercial advertisements, specifically, the promise of debt relief without any reference to the possibility of filing for bankruptcy, which has inherent costs. The disclosures entail only an accurate statement identifying the advertiser's legal status and the character of the assistance provided, and the disclosures do not prevent debt relief agencies from conveying any additional information. *Milavetz, Gallop & Milavetz, P.A. v. U.S.*, — S.Ct. —-, 2010 WL 757616 (U.S. Mar 08, 2010) (NO. 08-1119, 08-1225)

Syllabus

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) amended the Bankruptcy Code to define a class of bankruptcy professionals termed "debt relief agenc[ies]." 11 U.S.C. § 101(12A). That class includes, with limited exceptions, "any person who provides any bankruptcy assistance to an assisted person ... for ... payment ..., or who is a bankruptcy petition preparer." *Ibid.* The BAPCPA prohibits such professionals from "advis[ing] an assisted person ... to incur more debt in contemplation of [filing for bankruptcy] ...." § 526(a)(4). It also requires them to disclose in their advertisements for certain services that the services are with respect to or may involve bankruptcy relief, §§ 528(a)(3), (b)(2)(A), and to identify themselves as debt relief agencies, §§ 528(a)(4), (b)(2)(B).

The plaintiffs in this litigation–a law firm and others (collectively Milavetz)–filed a preenforcement suit seeking declaratory relief, arguing that Milavetz is not bound by the BAPCPA's debt-relief-agency provisions and therefore can freely advise clients to incur additional debt and need not make the requisite disclosures in its advertisements. The District Court found that "debt relief agency" does not include attorneys and that §§ 526 and 528 are unconstitutional as applied to that class of professionals. The Eighth Circuit affirmed in part and reversed in part, rejecting the District Court's conclusion that attorneys are not "debt relief agenc[ies]"; upholding application of § 528's disclosure requirements to attorneys; and finding § 526(a)(4) unconstitutional because it broadly prohibits debt relief agencies from advising assisted persons to incur *any* additional debt in contemplation of bankruptcy even when the advice constitutes prudent prebankruptcy planning.

Held:
1. Attorneys who provide bankruptcy assistance to assisted persons are debt relief agencies under the BAPCPA. By definition, "bankruptcy assistance" includes several services commonly performed by attorneys, *e.g.*, providing "advice, counsel, [or] document preparation," § 101(4A). Moreover, in enumerating specific exceptions to the debt-relief-agency definition, Congress indicated no intent to exclude attorneys. See §§ 101(12A)(A)-(E). Milavetz relies on the fact that § 101(12A) does not expressly include attorneys in advocating a narrower understanding. On that reading, only a bankruptcy petition preparer would qualify-an implausibility given that a "debt relief agency" is "any person who provides any bankruptcy assistance ... or who is a bankruptcy petition preparer," *ibid.* Milavetz's other arguments for excluding attorneys are also unpersuasive. Pp. — - —.

2. Section 526(a)(4) prohibits a debt relief agency only from advising a debtor to incur more debt because the debtor is filing for bankruptcy, rather than for a valid purpose. The statute's language, together with its purpose, makes a narrow reading of § 526(a)(4) the natural one. *Conrad, Rubin & Lesser v. Pender,* 289 U.S. 472, 53 S.Ct. 703, 77 L.Ed. 1327, supports this conclusion. The Court in that case read now-repealed § 96(d), which authorized reexamination of a debtor's attorney's fees payment "in contemplation of the filing of a petition," to require that the portended bankruptcy have "induce[d]" the transfer at issue, *id.*, at 477, 53 S.Ct. 703, understanding inducement to

engender suspicion of abuse. The Court identified the "controlling question" as "whether the thought of bankruptcy was the impelling cause of the transaction," *ibid.* Given the substantial similarities between §§ 96(d) and 526(a)(4), the controlling question under the latter is likewise whether the impelling reason for "advis[ing] an assisted person ... to incur more debt" was the prospect of filing for bankruptcy. In practice, advice impelled by the prospect of filing will generally consist of advice to "load up" on debt with the expectation of obtaining its discharge. The statutory context supports the conclusion that § 526(a)(4)'s prohibition primarily targets this type of conduct. The Court rejects Milavetz's arguments for a more expansive view of § 526(a)(4) and its claim that the provision, narrowly construed, is impermissibly vague. Pp. —- -—.

3. Section 528's disclosure requirements are valid as applied to Milavetz. Consistent with Milavetz's characterization, the Court presumes that this is an as-applied challenge. Because § 528 is directed at misleading commercial speech and imposes only a disclosure requirement rather than an affirmative limitation on speech, the less exacting scrutiny set out in *Zauderer v. Office of Disciplinary Counsel of Supreme Court of Ohio,* 471 U.S. 626, 105 S.Ct. 2265, 85 L.Ed.2d 652, governs. There, the Court found that, while unjustified or unduly burdensome disclosure requirements offend the First Amendment, "an advertiser's rights are adequately protected as long as disclosure requirements are reasonably related to the State's interest in preventing deception of consumers." *Id.* at 651, 105 S.Ct. 2265. Section 528's requirements share the essential features of the rule challenged in *Zauderer.* The disclosures are intended to combat the problem of inherently misleading commercial advertisements, and they entail only an accurate statement of the advertiser's legal status and the character of the assistance provided. Moreover, they do not prevent debt relief agencies from conveying any additional information through their advertisements. *In re R.M. J.,* 455 U.S. 191, 102 S.Ct. 929, 71 L.Ed.2d 64, distinguished. Because § 528's requirements are "reasonably related" to the Government's interest in preventing consumer deception, the Court upholds those provisions as applied to Milavetz. Pp. —- -—.

541 F.3d 785, affirmed in part, reversed in part, and remanded.

SOTOMAYOR, J., delivered the opinion of the Court, in which ROBERTS, C.J., and STEVENS, KENNEDY, GINSBURG, BREYER, and ALITO, JJ., joined, in which SCALIA, J., joined except for n. 3, and in which THOMAS, J., joined except for Part III-C. SCALIA, J., and THOMAS, J., filed opinions concurring in part and concurring in the judgment.

Ninth Circuit

Does the bankruptcy trustee, as a bona fide purchaser for value, have constructive notice of an unrecorded lien listed in debtor's bankruptcy schedules?

Ninth Circuit holds that, under strong arm power of § 544(a)(3), the trustee's status as a bona fide purchaser without notice is not altered by the fact that the debtor listed an unrecorded lien in debtor's bankruptcy schedules. *In re Deuel,* — F.3d —, 2010 WL 309031, 10 Cal. Daily Op. Serv. 1192, 2010 Daily Journal D.A.R. 1531 (9th Cir. Jan 28, 2010) (NO. 07-55266).

This case arises out of repeated home refinancing to take advantage of rising real estate values. Debtor Jill Deuel and her ex-husband Will Deuel bought a condominium in California in 1999. They borrowed $106,700 from North American Mortgage Company, secured by a duly recorded deed of trust. Two years later, on June 6, 2001, they refinanced, this time borrowing $122,400 from American Mortgage Express Financial Corp., again secured by a duly recorded deed of trust. The Deuels used this loan to pay off the prior North American loan. This second loan was assigned to Chase Manhattan in May 2002, and the assignment was duly recorded.

The problem giving rise to this case arises from the Deuel's third loan, the second time they refinanced and drew more equity out of their condo, in 2002. This time they borrowed $136,000 from Chase Manhattan and gave Chase Manhattan a deed of trust to secure their note. Somehow Chase Manhattan failed to get the deed of trust recorded. What did get recorded was the deed of reconveyance from the previous loan, which was paid off in full out of the new loan. Thus as far as anyone could tell from the county records, the condo had been paid off and there was no longer a lien against it.

The next year, in 2003, Ms. Deuel filed for a chapter 13 bankruptcy. That case was dismissed on the motion of the chapter 13 trustee. A year later, in 2004, she again filed for bankruptcy, this time under chapter 7. This 2004 case is the decided *Deuel* case. The appellee, Taxel, is the trustee for Deuel's chapter 7 bankruptcy. Deuel filed electronically. Along with her petition, she filed her schedules, listing Chase Manhattan's secured debt.

Chase Manhattan filed a complaint to quiet title to its lien, and prevailed in Bankruptcy Court on the theory that under the decision in Briggs v. Kent (*In re Professional Investment Properties of America*) 955 F.2d 623 (9th Cir.1992) her schedules provided constructive notice to the bankruptcy trustee of Chase Manhattan's unrecorded lien, and alternatively, that it was subrogated to its own previous recorded lien because it had used the new loan to pay it off. The Bankruptcy Appellate Panel reversed, ruling in favor of the trustee, distinguishing *Professional Investment,* and rejecting the subrogation theory. Chase Manhattan appealed.

The Ninth Circuit distinguished *Professional Investment* because that case is limited to involuntary petitions that give notice of an interest. The not yet existing trustee, under *Professional Investment,* cannot be a hypothetical bona fide purchaser *without notice* when the petition is filed where the duly filled out form of the petition itself gives notice. The trustee is then like a purchaser *with* notice. The Court did not address the controversy about whether *Professional Investment* was correctly decided, since it has no application to a voluntary petition. Voluntary and involuntary petitions operate differently in many respects: one is filed by the debtor, the other by a creditor; one does not list claims, the other states what interest the creditor filing it has.

Bankruptcy continues from **Page 13**

The Ninth Circuit affirmed the holding of the Bankruptcy Appellate Panel in favor of the bankruptcy trustee. and held that: (1) mere fact that Chapter 7 debtor filed her bankruptcy schedules earlier than she needed to, simultaneously with filing of petition, and that she listed her debt to deed of trust lender as secured debt on schedules, did not provide trustee with constructive notice of lender's unrecorded lien, of kind sufficient to affect trustee's ability to avoid lien in exercise of strong-arm powers as hypothetical bona fide purchaser, and (2) for policy reasons the deed of trust lender could not assert equitable subrogation claim to prejudice of trustee and other estate creditors. Affirmed.

Ninth Circuit

Is a transfer of property made pursuant to a state court judgment dissolving debtor's marriage a fraudulent transfer under § 548 in the absence of fraud, collusion, or violation of state law?

The Ninth Circuit held that a transfer of property made pursuant to a state court judgment dissolving debtor's marriage is not a fraudulent transfer under § 548 in the absence of fraud, collusion, or violation of state law. *In re Bledsoe*, 569 F.3d 1106, Bankr. L. Rep. (CCH) P 81517 (9th Cir. 2009).

The Ninth Circuit had to decide under what circumstances a federal bankruptcy court may avoid a transfer made pursuant to a state-court judgment dissolving the marriage of the debtor. The Court held that, under Oregon law, a party who challenges a dissolution judgment must allege and prove "extrinsic fraud." Following the lead of the Fifth Circuit in *Ingalls v. Erlewine (In re Erlewine),* 349 F.3d 205 (5th Cir.2003), the Court also held that a dissolution judgment that follows from a regularly conducted, contested divorce proceeding conclusively establishes "reasonably equivalent value" under 11 U.S.C. § 548(a)(1)(B) in the absence of fraud, collusion, or violation of state law.

Ninth Circuit, First Circuit

If an individual debtor in a voluntary case under chapter 7 or 13 fails to file all of the information required under subsection 521(a)(1) within 45 days after the date of the filing of the petition, does the bankruptcy court have the discretion to waive the subsection 521(i)(1) provision that the case shall be automatically dismissed effective on the 46th day after the date of the filing of the petition?

As a matter of the first impression in the Ninth and First Circuits, the courts of appeal held that the bankruptcy court retains discretion to waive the § 521(a)(1) filing requirement even after the § 521(i)(1) filing deadline has passed. *See Segarra-Miranda v. Acosta-Rivera (In re Acosta-Rivera),* 557 F.3d 8, 9 (1st Cir.2009) and *In re Warren*, 568 F.3d 1113, 62 Collier Bankr.Cas.2d 134, (9th Cir.(Cal.) Jun 18, 2009) (NO. 07-17226). The Bankruptcy Code provides:

§ 521. Debtor's duties
(a) The debtor shall–
(1) file –
(A) a list of creditors; and
(B) *unless the court orders otherwise*–
(i) a schedule of assets and liabilities;
(ii) a schedule of current income and current expenditures;
(iii) a statement of the debtor's financial affairs and, if section 342(b) applies,

***

(i) (1) Subject to paragraphs *** if an individual debtor in a voluntary case under chapter 7 or 13 fails to file all of the information required under subsection (a)(1) within 45 days after the date of the filing of the petition, the case shall be automatically dismissed effective on the 46th day after the date of the filing of the petition. [emphasis added]

The Ninth Circuit found the language of 521 to be ambiguous on whether subsection (i)(1)'s forty-five day filing deadline limits the power of a court to "order[ ] otherwise" and waive the § 521(a)(1) filing requirement. Given the ambiguity in the statutory language, the court had to evaluate the alternative readings in light of the purpose of the statute. *See* 11 U.S.C. §§ 521(a)(1)(B), (i)(1). *In re Warren,* 568 F.3d 1113, 1117. The Ninth Circuit reasoned that limiting the bankruptcy court's authority to waive the § 521(a)(1) filing requirement to the forty-five day period after the filing of the petition will encourage bankruptcy abuse because an abusive and manipulative debtor could guarantee his case would be dismissed simply by declining to comply with the § 521(a)(1) filing requirement. *In re Warren,* 568 F.3d 1113, 1118. The Ninth Circuit recognized that their interpretation of § 521 is in conflict with the majority of the bankruptcy and district courts to address this issue. *Id.*

Fourth Circuit

Does fee-shifting statute, 28 U.S.C.A. § 1447(c), which authorizes payment of costs and attorney's fees incurred as a result of improper removal from state to federal court, apply to the litigants but not to their attorneys?

Addressing an issue of first impression in the circuit courts, the Fourth Circuit held that the fee-shifting statute, 28 U.S.C.A. § 1447(c), which authorizes payment of costs and attorney's fees incurred as a result of improper removal from state to federal court, applies to the litigants but not to their attorneys. *MR Crescent City, LLC v. Draper (In re Crescent City Estates, LLC),* 588 F.3d 822 (4th Cir. 2009).

First Circuit

What is required to reopen no-asset chapter 7 cases to list new creditors for the first time and obtain a discharge of the debts?

In May 2009, the First Circuit addressed reopening no-asset chapter 7 cases to list new creditors for the first time. *See Colonial Surety Co. v. Weizman,* 564 F.3d 526 (1st Cir. 2009). *Weizman* held that no-asset debtors in chapter 7 could ask the bankruptcy court to reopen the case to belatedly list a creditor who was innocently omitted and who would have received no benefit from notice of the original case. *Id.* at 532. In its holding, *Weizman* relied primarily on the language of § 523(a)(3)(A), which precludes discharge of an unlisted debt when the creditor did not receive notice or have actual knowledge of the filing of the bankruptcy case. The Circuit thus expressly agreed with the Seventh Circuit's approach in *Stark v. St. Mary's Hosp. (In re Stark*), 717 F.2d 322 (7th Cir.1983). *See Weizman,* 564 F.3d at 532. On the other hand, *Weizman* also rejected the Ninth Circuit's competing "no harm, no foul" approach derived from *Beezley v. California Land Title Co. (In re Beezley*), 994 F.2d 1433 (9th Cir.1993), which states that dischargeability is unaffected by amending schedules in a no-asset, no-bar date case, so reopening to schedule a debt is a useless gesture and is thus not allowed. *See Weizman,* 564 F.3d at 531. The First Circuit thought *Beezley* essentially put the burden on the un-notified creditor, contrary to what Congress had in mind. *Id.* In essence, the court thought that § 523(a)(3)(A) "aims to assure creditor notice before discharge," because "no-asset claims are easy to make; a creditor might want notice precisely to argue that there are assets even though the debtor asserts otherwise." *Id.* at 531, 532.

Accordingly, in *Weizman,* the First Circuit unequivocally put the burden on the debtor to demonstrate cause to reopen. The debtor has the burden "to show that the law and equities justify [the] relief–absent which the debt will remain undischarged."*Id.* at 532. So, "a debtor who moves to reopen to list a debt long after discharge surely must show that the omission was innocent, and, even so, can probably be countered by anything that makes it inequitable to grant such relief." *Id.* In other words, debtors seeking to reopen to list a debt must show: (1) the omission was innocent, and (2) the equities justify reopening. If it was not clear before, it is now. Debtors cannot simply recite a generic explanation that the omission was innocent without some further factual detail.

In *In re Corbett,* — B.R. —, 2010 WL 768760 (Bankr.D.N.H. 2010), the court explained: "In light of *Weizman,* future motions in this district to reopen no-asset chapter 7 cases to add creditors will be governed by a slightly different procedure. In the first instance, debtors filing motions to reopen must submit either a verified motion or include an affidavit signed by the debtor providing facts sufficient for the Court to find that the debtor has met the burden of showing that: (1) the omission was innocent, and (2) the equities justify reopening the case to list the omitted creditor or creditors. If established, the Court will then issue an order, largely consistent with '*Walker* orders,' that provide the omitted creditor with notice and an opportunity to object. The Court anticipates that in the vast majority of cases, the omitted creditor will not take any action and the case will be reopened for that limited purpose."

Third Circuit

In a diversity action following a bankruptcy proceeding to determine whether a mortgagor is barred by the doctrine of res judicata, is state or federal law of res judicata applied?

In this case, the issue on appeal was whether the mortgagor Munozes's claim under the Pennsylvania Deficiency Judgment Act is barred by the doctrine of res judicata. Initially, the Third Circuit Court noted that although both the District Court and the parties assumed that federal law of res judicata applies, the Third Circuit Court held that they must apply Pennsylvania state law of res judicata. Following the Supreme Court's decision in *Semtek Intern. Inc. v. Lockheed Martin Corp.,* 531 U.S. 497, 121 S.Ct. 1021, 149 L.Ed.2d 32 (2001), the Third Circuit Court held that "[i]n a diversity action we apply the preclusion rules of the forum state, unless they are incompatible with federal interests." *Houbigant Inc. v. Fed. Ins. Co.,* 374 F.3d 192, 205 (3d Cir.2004). *See also Taylor v. Sturgell,* — U.S. —, 128 S.Ct. 2161, 2171 n. 4, 171 L.Ed.2d 155 (2008) ("For judgments in diversity cases, federal law incorporates the rules of preclusion applied by the State in which the rendering court sits.") (citation omitted); *Semtek Intern.,* 531 U.S. at 508, 121 S.Ct. 1021 (holding state claim preclusion law should apply in a diversity case). As this is a diversity case, and Pennsylvania is the forum state, Pennsylvania, not federal, preclusion law should apply.

Res judicata precluded mortgagors from pursuing their claim against mortgagee under the Pennsylvania Deficiency Judgment Act when they could have previously brought the claim before the Bankruptcy Court in the bankruptcy proceeding. In both actions, the thing sued upon was the sale of the home. Mortgagee, as a creditor of mortgagor, was a party to the bankruptcy proceeding, both parties appeared in the same capacity in both actions, and the subject matter, satisfying the deficiency judgment, was the same in both actions. The ultimate issue, using the sale of mortgagor's property to satisfy the deficiency, was also the same. *Munoz v. Sovereign Bank,* 323 Fed.Appx. 184 (3rd Cir.(Pa.) 2009) (NO. 07-2690).

First Circuit Bankruptcy Appellate Panel

Does 11 U.S.C.A. § 108(c) toll a state law provision requiring creditors to initiate foreclosure actions on mortgages within five years of their maturity date, regardless of whether state law establishes a procedure for creditors to extend the allowable period for enforcement?

First Circuit BAP holds that 11 U.S.C.A. § 108(c) tolls a state law provision requiring creditors to initiate foreclosure actions on mortgages within five years of their maturity date, regardless of whether state law establishes a procedure for creditors to extend the allowable period for enforcement. *In re 201 Forest Street, LLC,* — B.R. —, 2010 WL 367558 (1st Cir.BAP (Mass.) Feb 02, 2010) (NO. BAP MW 09-023, 07-42296-JBR, 07-41768-JBR).

This appeal involves the interplay of Bankruptcy Code §§ 108(c) and 362(b)(3) and the Massachusetts Obsolete Mortgages Statute.[11] On the motion of the chapter 11 debtor, 201 Forest Street LLC ("Forest Street" or the "debtor"), the bankruptcy court entered an order (the "Discharge Order") discharging a mortgage held by LBM Financial, LLC ("LBM") on the debtor's property. The bankruptcy court held that the mortgage was discharged by the passage of time and the operation of the Obsolete Mortgages Statute.

The Bankruptcy Appellate Panel reversed, concluding that LBM's right to enforce its mortgage was extended during the course of Forest Street's reorganization by § 108(c), notwithstanding state law. The BAP held this to be the case notwithstanding the possibility that LBM might have extended the length of time its mortgage remained viable by filing an affidavit in the appropriate Massachusetts registry of deeds, an avenue the bankruptcy court determined was available to LBM without relief from the automatic stay via § 362(b)(3). ■

Prof. Dunaway, Section Editor, is also Professor Emeritus at Pepperdine University School of Law.

[1] Mass. Gen. Laws ch. 260, § 33 (2009).

Business continues from **Page 1**

In general, the positions of the various stakeholders should be understood with the intention of treating those of a similar nature consistently and not allowing respective positions to deteriorate or improve at the expense of others. It is key, early in the process, to have stakeholders "stand still" to preserve value and allow time to develop long-term solutions. More importantly, by having stakeholders stand still, one stakeholder is not improving its position over another. This assists in establishing credibility and confidence in the process which generally increases the degree of cooperation the stakeholders may be willing to provide.

Developing a Broad Understanding of the Various Stakeholders' Interests, Demands and Potential Actions

During the first week of a business crisis, the establishment of communication with various stakeholders is critical. Typically, outsiders are not aware of the severity of the problems, have been provided little information and in many cases have become frustrated, irritated or even begun to take action against the company for lack of performance (delivery, quality and other issues), lack of timely payment to the trade, violation of loan covenants or out-of-formula borrowing positions, or other issues.

By communicating with the various stakeholders, their issues and concerns become known and better defined, realistic expectations can be established and, hopefully, confidence that the situation, as bad as it may be, is at least being handled in a constructive, professional and forthright manner. Key factors in communication with certain stakeholders are presented in Exhibit 1 below.

Part of the initial communication should be the establishment of a communication process. How and when will the constituents be updated? Who do they contact with specific concerns? How will discrepancies of fact get resolved and with whom? What specific authorization or reporting is required?

Implementing Processes to Control and Manage Critical Activities If an outside turnaround specialist is retained by the company, the roles, responsibilities and authority of management will need to be redefined. Decision making processes will need modification. Cash control and cash management are critical processes during this phase and should reside with the turnaround specialist. Too often, at least initially, company personnel will be unable to make objective decisions regarding the use of cash in a survival mode. Past practices such as making payments for non-essential items or allowing suppliers to accelerate terms are hard to change.

Understanding the cash balance per book on a real time basis is necessary, including the daily projection and management of cash receipts, borrowing availability and cash disbursements. Cash flow forecasts must be updated on a daily basis for two- to four-weeks out. Following initial stabilization (after week one), the preparation of a rolling 13-week cash flow forecast needs to be established.

Processes for generating new reporting need to be established, such as more frequent (even daily) and detailed borrowing base filings, cash disbursements by expense category (as forecasted), weekly cash flow of budget to actual analysis, and other information. Additional examples of week one processes include the daily identification and procurement of critical items required to maintain the revenue stream and the management of vendor issues to ensure continued supply. Tracking of COD payments and the related goods received and invoicing documentation and reconciliation is important as vendors begin to require COD payments. All of these activities should be performed under the authority and guidance of the turnaround professional.

Summary For a business in crisis, week one is a very hectic and challenging time. It is important to obtain the broadest understanding of the situation and issues while digging deeper where required to deal with key issues. Short-term cash flow and survival are generally the top priorities. As conditions begin to stabilize, a longer term focus can be undertaken. As early as possible, efforts should be made to understand the mid-term and long-term viability of the organization. The viability of the entity is required for the various stakeholders to assess the situation and to identify possible solutions that meet the needs of the constituents.

The above discussion of key activities required in the first

Exhibit 1–First Week Communications

Suppliers	• Communicating Company status, go forward plan of action, and proposed resolution plan for amounts owed • Understanding actions taken, legal, delivery stoppage, and accelerated payment demands, etc. • Stand still request, COD for new shipments, if required
Creditors	• Communication of Company status, go forward plan of action, and timing • Reconciliation of current loan status, funding request, cash flow forecast
Customers	• Communication of Company status, go forward plan of action, and timing • Shipment status, backlog, quality issues, expedited freight, new program timing and funding
Employees	• Communication of Company status, go forward plan of action, and timing

week of business crisis is not exhaustive (for example, other actions would be required should a company file for bankruptcy, or when a bank refuses to continue lending), and certain examples may not apply in all situations. For a basic checklist of week one items, please go to our website www.hydrapros.com or contact us at your convenience. ■

About HYDRA Professionals

Scott Smith is a Senior Director at HYDRA Professionals, LLC. Scott can be contacted at (248) 766-0885 or by e-mail at ssmith@hydrapros.com. HYDRA Professionals, located in Farmington Hills, Michigan, is a premier business advisory firm to companies across multiple industry sectors that specializes in identifying significant opportunities and developing and implementing solutions to achieve positive results.

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201.528.4167
fred.vanalstyne@contentcritical.com

John Curtis
Rocky Mountain Advisory, LLC
215 South State Street, Suite 550
Salt Lake City, UT 84111
801.428.1604
jcurtis@rockymountainadvisory.com

Stephen Scherf
Asterion, Inc.
215 S Broad Street, 3rd Floor
Philadelphia, PA 19107
215.893.9923
sscherf@asterion-consulting.com

Greg Richards
Sun-Times Media Group
350 N. Orleans St.
Chicago, IL 60654
312.321.6426
grichards@suntimes.com

Gil Miller
Rocky Mountain Advisory
215 South State Street, Suite 550
Salt Lake City, UT 84111
801.537.5254
gmiller@rockymountainadvisory.com

Robert Rakowski
Fifth Street Finance Corp.
10 Bank Street, 12th Floor
White Plains, NY 10606
914.286.6832
rrakowski@fifthstreetcap.com

Ted Lackowitz
Graf Repetti & Co., LLP
131 Sunnyside Blvd, Suite 110
Plainview, NY 11803
516.349.2150
tlackowitz@grafrepetti.com

Neil Gilmour III
Invotex Group
1717 Arch Street, Suite 4030
Philadelphia, PA 19103
267.687.4728
ngilmour@invotex.com

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