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Where is *Stern v. Marshall* Going to End Up?

Grant T. Stein
Alston+Bird LLP

Stern v. Marshall, 131 S.Ct. 2594 (2011), understandably has led to a substantial amount of litigation about the scope of the judicial authority of the Bankruptcy Court. Is it really anything new? Is it simply a return to the *summary/plenary* jurisdiction that recognized the limits in the judicial authority of the bankruptcy judge where a litigant has not filed a proof of claim? *See Katchen v. Landy*, 382 U.S. 323 (1966); *Stern*, 131 S.Ct. at 2620–21 (Scalia J., concurring). Nothing in *Stern* has limited or removed the bankruptcy court's ability to consider relief from the automatic stay, valuation, use of cash collateral, post-petition lending, discharge, dischargeability, exemptions, plan confirmation, union contracts, and component issues under 11 U.S.C. §§ 362, 363, 364, 506, 522, 523, 727, 1225, 1325, 1113, 1114, and 1129, as examples. What *Stern* has affected is the ability to engage in the exercise of judicial power in litigation where the claims allowance process is not directly implicated, even if the suit at issue is "core," such as with a counterclaim to the claim, as occurred in *Stern*. *See also Ortiz v. Aurora Health Care, Inc. (In re Ortiz)*, 665 F.3d 906 (7th Cir. 2011). In *Ortiz*, after the district court denied a request to withdraw the reference because the claims at issue were "core," and the bankruptcy court later entered summary judgment (a final order) on a counterclaim to a proof of claim as to whether the filing of a proof of claim containing medical information violated state law, the Seventh Circuit vacated an order authorizing a direct appeal because the bankruptcy court lacked judicial authority over the state law based counterclaim despite being core under 28 U.S.C. § 157(b)(2)(C). These issues have led to a focus on an aspect of the Bankruptcy Court's judicial authority, or the absence thereof.

For example, in *In re Bellingham Insurance Agency, Inc.*, 661 F.3d 476 (9th Cir. 2011), the Ninth Circuit Court of Appeals specifically asked for amicus briefing on the issues of whether a final order can be entered on a statutorily core fraudulent conveyance claim, 28 U.S.C. § 157(b)(2)(H), and if not, whether proposed findings of fact and conclusions of law can lawfully be issued by the Bankruptcy Court. The Ninth Circuit stated:

> The court invites supplemental briefs by any amicus curiae addressing the following questions: Does *Stern v. Marshall*, —— U.S. ——, 131 S.Ct. 2594, 180 L.Ed.2d 475 (2011), prohibit bankruptcy courts from entering a final, binding judgment on an action to avoid a fraudulent conveyance? If so, may the bankruptcy court hear the proceeding and submit a report and recommendation to a federal district court in lieu of entering a final judgment?
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> 661 F.3d at 476.

The statutory authority for the Bankruptcy Court to enter proposed findings of fact and conclusions of law is found in 28 U.S.C. § 157(c)(1), which states:

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

There is no similar statutory provision that addresses issuing proposed findings of fact and conclusions of law for a core matter over which judicial authority is absent under *Stern*. Section 157(b) of the United States Code, which proscribes a bankruptcy court's authority to address "core" claims, does not address

Stern v. Marshall *continues on p. 6*

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Letter from the President

Anthony V. Sasso, CIRA
Deloitte Financial Advisory Services LLP

Hello and thank you to fellow AIRA members—This is my inaugural President's Letter and I would like to start by thanking the entire Board for their support in selecting me to serve as AIRA's President. It is truly an honor. In this new role I plan to do my best to live up to the expectations of the Board and the greater AIRA community.

My AIRA Experience—My personal history with the AIRA began in 1996 when my career in accounting at Deloitte transitioned into the restructuring arena. I joined with the specific intention of earning the CIRA Certification. Although not as well known then as it is today, the CIRA program provided me with a solid foundation of knowledge to build on, knowledge I found to be invaluable as I began to work more extensively in the Chapter 11 environment. The first annual conference I attended was the 14th Annual in 1998. Here we are 14 years later, having completed the 28th Annual in San Francisco. Over this 14 year period, I have supported the organization through committee involvement and in other roles, attended at least ten Annual Conferences, and served on the Board since 2004. Without a doubt, these experiences have been one of my most important sources of formal training in restructuring. Over the years, I have watched the AIRA continue to grow, both in terms of members and in the stature of the organization in its relationship to our profession. Its contributions to the education of our membership and the restructuring community in general have been enormous. Beyond the obvious educational benefits, the annual conference and regional conferences have also been a great source of networking for us all and the source of many new friendships.

For those of you who have attended AIRA functions, have spoken on panels or have otherwise been involved with this great organization, whether you are a newer member or have been part of the AIRA family longer than I have, I am confident that you have enjoyed similar rich experiences.

The AIRA Staff—I would be remiss to not recognize the many valuable contributions of the AIRA staff. The current members include Terry Jones (Director of CIRA and

CDBV Programs), Lauren Cypher (Conferences and Marketing Coordinator), Lorren Biffin (Director of Information Technology), Elysia Harland (Controller), Valda Newton (Executive Assistant), Michele Michael (Administrative Assistant), and Mary Hamilton (Administrative Assistant). I could not be more impressed by the performance of the AIRA team, as clearly evidenced by the recently completed Annual Conference in San Francisco. As all would agree, this event was extremely well run and of outstanding quality. I found the balance of educational content, social activities and networking opportunities to be just right. A key reason for the great success of this event was the hard work, high energy level and great team atmosphere demonstrated by the AIRA staff. Last but not least, I extend a special thanks to **Grant Newton**, the Executive Director of the AIRA, who is more responsible than anyone for the great success the AIRA has enjoyed and the respect it has earned over the years. He has also been a very good friend and someone I respect and admire for his hard work and great knowledge of the profession.

The Future—As to next year's goals, the first with respect to the many activities scheduled for the upcoming year is to maintain the high standards our membership has come to enjoy, which includes keeping our members current on what is happening in the profession, providing outstanding training for our practitioners, and fostering professional relationships and friendships for years to come.

Thank you again and I look forward to seeing you at an AIRA event soon!

Tony Sasso

Anthony Sasso

Executive Director's Column

Grant Newton, CIRA
AIRA Executive Director

FASB Issues Exposure Draft on Liquidation Basis of Accounting

The FASB in issuing the exposure draft for a standard dealing with liquidation basis of accounting noted there is minimal guidance that addresses when it is appropriate to apply, or how to apply, the liquidation basis of accounting. The FASB stated that guidance in the proposed amendments is intended "to clarify when an entity should apply the liquidation basis of accounting and to provide principles for the measurement of assets and liabilities under the liquidation basis of accounting as well as any required disclosures." According to the FASB the proposed amendments would apply to all entities that issue financial statements that are presented in conformity with U.S. generally accepted accounting principles (GAAP).

The proposed amendments, according to the FASB, would require an entity to prepare its financial statements using the liquidation basis of accounting when liquidation is imminent. The Board decided liquidation would be considered imminent when either (a) a plan for liquidation has been approved by the person or persons with authority to make such a plan effective and likelihood is remote that execution of the plan will be blocked by other parties, or (b) a plan for liquidation is being imposed by other forces (e.g., involuntary bankruptcy) and likelihood is remote that the entity will subsequently return from liquidation. If a plan for liquidation was specified in the entity's governing documents at inception (e.g., limited-life entities), liquidation would be considered imminent when significant management decisions about furthering ongoing operations of the entity have ceased or are substantially limited to those necessary to carry out a plan for liquidation other than the plan specified at inception.

According to the FASB, the proposed amendments also would require financial statements prepared using the liquidation basis to reflect relevant information about an entity's resources and obligations in liquidation by measuring and presenting assets and liabilities in the entity's financial statements at the amount of cash or other consideration that the entity expects to collect, or the amount of cash or other consideration that the entity expects to pay, during the course of liquidation. An entity also would be required to accrue and separately present costs that it expects to incur and income that it expects to earn during the expected duration of the liquidation, including any costs associated with settlement of those assets and liabilities.

AIRA's Board is establishing a special committee to respond to the draft, especially the relationships between chapter 7 or 11 liquidations, including the timing of the application and the proposed standard. Members interested in serving on the committee should send an email to gnewton@aira.org

Best Regards,

Grant

Grant Newton

Why Restructuring Professionals Should Care About the Perishable Agricultural Commodities Act

Teri Stratton, CIRA
Piper Jaffray

While I happen to specialize in agriculture, and therefore have a working knowledge of federal and state statutes that are unique to the sector, it still surprises me how few experienced restructuring professionals know or care about the Perishable Agricultural Commodities Act of 1930 ("PACA", as amended 7 U.S.C. §499a-t). Even now, reading a restructuring trade publication, you are probably thinking, I don't deal with agriculture, so why should I care?

Simply put, PACA is not just about agriculture. PACA governs a broad spectrum of businesses that purchase agricultural commodities including produce brokers and food manufacturers. In addition, restaurants and grocery retailers that purchase more than $230,000 of produce annually can be subject to PACA.

Imagine you are working with a restaurant that might file Chapter 11. PACA is something the attorneys can deal with post-filing, like a mechanic's lien, right? Wrong! PACA has very serious and immediate cash flow implications both prior to and after filing. If PACA is not top-of-mind in your budget planning and DIP discussions, you could find the debtor to be administratively insolvent shortly after filing for bankruptcy protection. Understanding the nuances of PACA can be the difference between a successful and a disastrous result for your client, whether they are a produce producer, purchaser or lender.

Background of Perishable Agricultural Commodities Act

PACA was enacted in 1930 and facilitates fair trading practices in the marketing of fresh and frozen fruits and vegetables in interstate and foreign commerce. The goal of PACA is to protect the small farmer or grower from irresponsible or unscrupulous business practices of produce brokers, and ensure that the supplier of perishable agricultural commodities ("Produce Supplier") gets paid for what they sell. In 1984, PACA was amended to give further priority to growers over secured lenders by creating a statutory trust for the benefit of Produce Suppliers requiring the purchaser to hold produce and anything derived from the sale of produce, including food products, receivables and other proceeds, in trust (the "Trust Assets"). This effectively gives qualified PACA trust beneficiaries priority over the claims of a produce purchaser's other creditors.

What is a Perishable Agricultural Commodity?

One of the most interesting and distressing distinctions surrounding PACA is what goods are actually protected by the Act. The broad definition of perishable agricultural commodities is "fresh fruits and fresh vegetables of every kind and character" whether or not frozen or packed in ice. Essentially, PACA is not intended to cover processed food. However, by definition in PACA, the following actions do not change the character of the fruit or vegetable:

> Water, steam, or oil blanching, chopping, color adding, curing, cutting, dicing, drying for the removal of surface moisture; fumigating, gassing, heating for insect control, ripening and coloring; removal of seed, pits, stems, calyx, husk pods, rind, skin, peel, et cetera; polishing, precooling, refrigerating, shredding, slicing, trimming, washing with or without chemicals; waxing, adding of sugar or other sweetening agents; addings ascorbic acid or other agents to retard oxidation; mixing of several kinds of sliced, chopped or diced fruit or vegetables for packaging in any type of containers; or comparable methods of preparation.
>
> 7 USC § 46.2(u) (2004)

Sounds simple—but what is and isn't covered is not always apparent. For example, raw nuts, mushrooms and herbs are covered by PACA, but juice, sugar cane, and dried fruits are not To add to the confusion, in 2003 in what many call the "French Fry Decision," the USDA determined that potatoes that have been battered, coated and made ready to fry are not technically processed (i.e., not changed into a food of a different kind or character) and are therefore covered under PACA.[1] I am not sure anyone would assume a french fry to be anything other than processed food; however, knowing the nuances of PACA would enable an advisor to properly account for payables related to french fry inventory and similar situations. For certain clients, making this distinction properly (or improperly) could have far reaching implications. When in doubt as to PACA coverage, I have a great fallback: call the PACA Branch at 202-720-2890.

Lending and Cash Flow Implications

The trust imposed by PACA is a non-segregated floating trust that provides a first priority security interest in the Trust Assets that prevails over other creditors, including those holding a pre-existing, perfected security interest in any personal property. Notably, this superpriority security interest does not require public disclosure of the trust.

From a lender's perspective, this lack of public disclosure can be problematic. A lender making a secured loan to a produce buyer cannot rely on the common practice of conducting a UCC search to determine that its security interest is a first priority lien. Lack of knowledge about the possibility for a priority lien can cause lenders to improperly assess and price collateral risk.

Additionally, a lender who forecloses on collateral that includes Trust Assets may be liable to the Produce Suppliers for the value of the Trust Assets. In order to protect themselves, lenders who are knowledgable about PACA concern themselves with the issue well in advance of any financial distress. To properly mitigate this risk, some lenders monitor the payment of PACA invoices. Others impose a borrowing base reserve for accounts payable

1 See *Fleming Companies, Inc. v. USDA*, 322 F Supp2d 744, 752 (ED Tex 2004), *aff'd*, 164 Fed Appx 528 (5th Cir 2006).

to Produce Suppliers. Even with a reserve, said lender needs to be comfortable that the borrower's accounts payable accurately reflect outstanding invoices. It is not uncommon for accounts payable discrepancies due to slow invoice processing or to have checks written for invoice payment get stuck in a drawer (a practice not uncommon for agriculture related businesses).

In a distressed situation, PACA also affects the cash flow of companies or debtors. First, as described above, lenders often reduce availability of borrowings by the accounts payable to Produce Suppliers. Depending on the value of lendable assets, the percentage of inventory subject to PACA, or the outstanding PACA accounts payable, this practice can seriously impair the company's credit availability as well as its ability to finance operations. Furthermore, in a bankruptcy context, PACA claims must be paid within a reasonable period of time after the filing date. From a liquidity standpoint, this means that the debtor must have the liquidity to pay the initial PACA claims and cannot put off payment to a time after a liquidity transaction (e.g., sale or equity infusion) has occurred as might happen with 503(b)(9) or other administrative claims. It is imperative that the payment of these claims be included in the DIP budget for payment early on in the case in order to avoid administrative insolvency.

Personal Liability for Directors and Officers

There is another critical reason for advisors to be concerned about PACA. The PACA trust imposes a fiduciary duty on officers and directors of a company to ensure that the Trust Assets are not depleted before Produce Suppliers are *paid in full*. A Produce Supplier may seek damages from a director or officer who breaches this fiduciary duty. Additionally, if a director or officer can be responsibly connected to a flagrant or repetitive PACA violation, they may be barred from employment by any PACA licensee for one year. This poses a significant risk to a client's directors and officers, and must be given due consideration when planning a bankruptcy filing.

Validity of PACA Claims – Plus: An Important New Amendment

In order for a PACA claim to be deemed valid, the Produce Supplier must adhere to the following procedures:

1. Send the produce buyer a written document entitled "Notice of Intent to Preserve PACA Trust Benefits" and file a copy with the US Department of Agriculture. The notice must contain enough detail to allow the produce buyer to identify the transactions subject to the trust and include certain specific information about the transaction. The notice must be given to the produce buyer within 30 days from the date payment was past due or receipt of notification that a payment instrument was dishonored.

   Alternatively, the face of the original bill or invoice statement must contain the following statement:

   > The perishable agricultural commodities listed on this invoice are sold subject to the statutory trust authorized by section 5(c) of the Perishable Agricultural Commodities Act (7 U.S.C. § 499e(c)). The seller of these commodities retains a trust claim over these commodities, all inventories of food or other products derived from these commodities, and any receivables or proceeds from the sale of these commodities until full payment is received.

2. Payment terms must be no greater than net 30 days from the delivery and acceptance of the produce and such terms must be written on the invoice.

If a Produce Supplier agrees either orally or in writing to terms greater than 30 days, the transaction(s) are not covered by PACA. Providing normal course terms greater than 30 days clearly invalidates the PACA trust. In the past, certain application of the terms provision often worked in direct contradiction to the stated goal of PACA, *viz*. ensuring that produce suppliers are paid for their goods. For example, when a produce buyer is going through a difficult financial period, they often negotiate payment plans with their trade creditors on past due invoices. If a Produce Supplier wanted to enter into such an agreement and extend payment beyond 30 days from delivery, the Produce Supplier's unpaid invoices subject to the agreement would become invalid PACA claims. This resulted in Produce Suppliers either unwittingly invalidating their PACA claims (putting them at greater risk) or forcing them to take a hard line with the customer, potentially exacerbating the customer's liquidity situation and pushing them closer to bankruptcy.

This is New In April 2011, PACA was amended to address the above conflict by providing that post-default agreements do not invalidate PACA coverage. This is a great win for Produce Suppliers and troubled companies as well. Produce Suppliers no longer waive their PACA trust when they are trying to work with their customers. Companies now may be able to work through a difficult liquidity situation through a negotiated payment plan with its PACA vendors, as opposed to prior to this amendment, when only the uninformed Produce Suppliers would ever agree to a post-default agreement.

Conclusion

Restructuring professionals who work with lenders, Produce Suppliers or companies who purchase fresh or frozen produce should have a basic understanding of PACA. Lenders need to adequately reserve for potential PACA trust amounts. Professionals representing Produce Suppliers should know their trust rights and ensure their actions do not result in waiver of those rights. Those working with purchasers of perishable agricultural commodities should keep track of the PACA trust in planning for a bankruptcy and provide for payment in full of the trust funds early in the case. ■

Teri Stratton, CIRA, is a Managing Director with Piper Jaffray & Co. where she focuses on capital markets, distressed mergers and acquisitions and restructuring advisory services. Before joining Piper in 2010, Stratton spent 10 years at Macquarie Capital Advisors (and predecessor firms). Prior to her investment banking career, she had 8 years experience in corporate banking, serving in both credit administration and special assets. She holds a Bachelor's in Economics, UCLA, and MBA Finance with Honors from The Anderson School, UCLA.

it. 28 U.S.C. § 157(b)(1). Though Section 157(b)(1) authorizes a bankruptcy court to "enter appropriate orders and judgments," the statute expressly provides that those orders and judgments are "subject to review under section 158 of this title." *Id.* 28 U.S.C. § 158, which requires a final order for appellate jurisdiction in the Court of Appeals, is not applicable to proposed findings of fact and conclusions of law which are, *per se*, not final orders. *See* 28 U.S.C. §§ 157(b)(1), 158.

Pursuant to the Supreme Court's authority, provided under 28 U.S.C. § 2057, to create procedural bankruptcy rules, Bankruptcy Rule 9033 states the following:

> In *non-core* proceedings heard pursuant to 28 U.S.C. § 157(c)(1), the bankruptcy judge shall file proposed findings of facts and conclusions of law.

The rule does not address the issuance of proposed findings of facts and conclusions of law on core issues over which there is no judicial authority.

The impact of *Stern* and *Ortiz*, and the language of 28 U.S.C. § 157(c)(1), is also addressed in minutes of the Subcommittee on Business Issues of the Advisory Committee on Bankruptcy Rules and the Advisory Committee on Bankruptcy Rules, respectively. The following discussions of this issue are reflected in these materials.

In the *Draft Minutes, Bankruptcy Rules Committee* for March 29-30, 2012, the following discussion of Section 157(c)(1) takes place:

> Third, *there is a potential for reading Stern v. Marshall as having created a complete jurisdictional hole in which a bankruptcy court may not be able to do anything at all in some cases — either to enter a final order or to submit proposed findings and conclusions.* He explained that 28 U.S.C. § 157(c) specifies that if a matter is not a "core" proceeding under 28 U.S.C. § 157(b), a bankruptcy judge may enter proposed findings of fact and conclusions of law for disposition by the district court. After *Stern v. Marshall*, some statutory "core" proceedings are now unconstitutional for the bankruptcy court to decide with finality. Therefore, there is a question as to whether 28 U.S.C. § 157(c), which specifically authorizes a bankruptcy judge to issue proposed findings and conclusions in "a matter that is not a core proceeding," refers only to matters that are not core under 28 U.S.C. § 157(b) or also includes matters that are not "core" under the Constitution.
>
> *If § 157(c) refers only to matters that are not "core" under the statute, bankruptcy judges would have no authority to issue proposed findings and conclusions of law in matters that the statute explicitly defines as "core" matters. And for some of these statutory "core" matters, the Constitution prevents bankruptcy judges from entering a final judgment. The potential void, he said, could arise relatively frequently.* It would apply to all counterclaims by a bankruptcy estate against creditors filing claims against the estate, and it might also be held to include fraudulent conveyance cases.
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> *Draft Minutes, Bankruptcy Rules Committee, Fall 2011* at 16, Advisory Committee on Bankruptcy Rules, March 29-30, 2012 (emphasis added).

An earlier discussion of *Ortiz* from March 15, 2012 was as follows:

> The decision in *Ortiz* warrants attention, not so much for its square holding but for some of the language in the opinion. Particularly noteworthy is its discussion of the question whether the bankruptcy judge's decision could be considered an interlocutory order from which a discretionary direct appeal could be permitted under 28 U.S.C. § 158(a)(3) and (d).[5] The court observed:
>
> > *For the bankruptcy judge's orders to function as proposed findings of fact or conclusions of law under 28 U.S.C. § 157(c)(1), we would have to hold that the debtors' complaints were "not a core proceeding" but are "otherwise related to a case under title 11." Id. As we just concluded, the debtors' claims qualify as core proceedings and therefore do not fit under § 157(c)(1).*
>
> *This language could be read to find that there is a no-man's land in the adjudication of Stern-barred claims. In other words, a bankruptcy court's decision in a proceeding deemed core as a statutory matter could not be treated as a final judgment if doing so would violate Article III under Stern, but it also could not be treated as proposed findings of fact and conclusions of law, because § 157(c)(1) speaks of the submission of proposed findings of fact and conclusions of law in "a proceeding that is not a core proceeding."* (emphasis added).
>
> [5] Section 158(d)(2)(A) permits a court of appeals to exercise jurisdiction over appeals described in the first sentence of § 158(a). Section 158(a)'s first sentence, in turn, includes appeals from "final judgments, orders, and decrees" of bankruptcy courts and "with leave of the court, from other interlocutory orders and decrees; and, with leave of the court, from interlocutory orders and decrees, of bankruptcy judges entered in cases and proceedings referred to the bankruptcy judges under section 157 of this title."
>
> *Rulemaking Responses to Stern v. Marshall* at 15–16, Subcommittee on Business Issues of the Advisory Committee on Bankruptcy Rules, March 15, 2012 (emphasis added).

The Seventh Circuit's analysis in *Ortiz* is contained in the following excerpts.

> Although the Court noted that the question presented was "narrow," it was quite significant as Congress "may no more lawfully chip away at the authority of the Judicial Branch than it may eliminate it entirely." 131 S. Ct. at 2620.
>
> * * *
>
> The answer to the second set of questions is straightforward. The bankruptcy judge's orders cannot be considered interlocutory under 28 U.S.C. § 158(a)(3), or final decisions, judgments, orders, or decrees within the

> meaning of 28 U.S.C. § 158(d)(1). The orders dismissed the debtors' complaints and ended the litigation and § 158(d)(1) only gives us "jurisdiction of appeals from all final decisions, judgments, orders, and decrees entered under subsections (a) and (b) of" § 158, which address the appellate jurisdiction of district courts and appellate panels. *For the bankruptcy judge's orders to function as proposed findings of fact or conclusions of law under 28 U.S.C. § 157(c)(1), we would have to hold that the debtors' complaints were "not a core proceeding" but are "otherwise related to a case under title 11." Id. As we just concluded, the debtors' claims qualify as core proceedings and therefore do not fit under § 157(c)(1).* The direct appeal provision in 28 U.S.C. § 158(d)(2)(A) also does not authorize us to review on direct appeal a bankruptcy judge's proposed findings of fact and conclusions of law.
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> *Ortiz*, 665 F.3d at 911, 915 (emphasis added).

The recent unanimous decision in *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 132 S.Ct. 2065, 2070-71 (2012), is also applicable as it addresses established principles of statutory construction and interpretation which help analyze the inclusion of non-core matters in 28 U.S.C. § 157(c)(1) and the exclusion of core matters from the statute. As Justice Scalia explained in *RadLAX Gateway Hotel, LLC*:

> A well-established canon of statutory interpretation succinctly captures the problem: "[I]t is a commonplace of statutory construction that the specific governs the general."
>
> * * *
>
> The general/specific canon is perhaps most frequently applied to statutes in which a general permission or prohibition is contradicted by a specific prohibition or permission. To eliminate the contradiction, the specific provision is construed as an exception to the general one. *See, e.g.*, *Morton* v. *Mancari*, 417 U. S. 535, 550–551 (1974).
>
> But the canon has full application as well to statutes such as the one here, in which a general authorization and a more limited, specific authorization exist side-by-side. There the canon avoids not contradiction but the superfluity of a specific provision that is swallowed by the general one, "violat[ing] the cardinal rule that, if possible, effect shall be given to every clause and part of a statute."

What is interesting if one reviews the cases from around the country is the number of them that do not discuss the statutory analysis addressed above. Clearly the Seventh Circuit has done so in *Ortiz*, and the Ninth Circuit is going to do so in *Bellingham*. Whether, in fact, there has been a return to the basic premises that long existed in the bankruptcy courts reflected in *Katchen v. Landy*, 382 U.S. 323 (1966) is yet to be determined. It is significant to note that the Bankruptcy Reform Act of 1978 was supposed to broaden the jurisdiction and judicial authority of the bankruptcy courts, and twice the Supreme Court has now indicated that Article III judicial power under the United States Constitution cannot be given to Article I judges. This happened first in *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982), and most recently in *Stern v. Marshall*. The final chapter has not yet been written and the question of whether United States District Court can use bankruptcy judges in a magistrate-like capacity in the absence of statutory authority to do so is yet to be finally determined. ■

Grant T. Stein is a senior partner and former chair of Alston & Bird LLP's Bankruptcy, Reorganization & Workouts Group. His diverse practice includes bankruptcy related litigation on behalf of numerous constituencies in addition to representation of debtors, fiduciaries, and secured and unsecured creditors in debt restructurings, bankruptcy cases and financial transactions. Mr. Stein is a former President and Chair of the AIRA and of the Southeastern Bankruptcy Law Institute, is a Fellow of the American College of Bankruptcy, and serves on its Board of Directors. Mr. Stein has written numerous articles on insolvency issues, and regularly lectures on insolvency topics.

Member in the News

Lawrence R. Ahern, III—Burr & Forman LLP

AIRA Board member and attorney at Burr & Forman LLP, Lawrence R. Ahern, III, has been recognized by Chambers USA as a "Leader in Their Field" in the area of Litigation: Bankruptcy. The qualities that determine rankings include technical legal ability, professional conduct, client service, commercial awareness/astuteness, diligence and commitment.

28th Annual Conference Highlights

2012 ZOLFO COOPER & RANDY WAITS MEDALS

Gold, silver, and bronze medals were presented during the Awards Banquet recognizing candidates that earned the top composite scores for all three parts of the CIRA exam completed by the previous year's end.

Gold: John Owens received a BBA in Finance from the University of Notre Dame in 1988. He then received his MBA from the Embry Riddle Aeronautical University in Daytona Beach, Florida in 2004. He is the Director of Restructuring & Turnaround with Huron Consulting Group in Chicago, IL and has been with them since 2010. Prior to Huron, John was a Restructuring Officer at Capital Source Finance in Chicago.

Silver: Andre Maksimow received a Bachelor of Science degree in Business Administration from Boston University School of Management in 1994. He then went on to receive his MBA, concentration in Finance, from the Boston University Graduate School of Management in 1996. Andre is currently a Vice President at Kaufman Hall in Chatham, New Jersey. Prior to Kaufman Hall, Andre was a Director at FTI Healthcare in New York City.

Bronze: Jeffrey Whetzel received a B.S. in Computer Science and Finance from Northern Illinois University in 1985. He then received his MBA from Northwestern University in 1988. Jeff is a Principal with the NewMGroup, LLC in Houston, Texas. Prior to NewMGroup, he was a member of the Corporate Advisory and Restructuring Services group at Grant Thornton. He currently lives in Houston and is active in his local community, including local school district Education Foundation and as a YMCA coach.

Candidates that fulfilled all requirements for CIRA or CDBV certification during the year were honored at the awards banquet.

CERTIFICATES OF DISTINGUISHED PERFORMANCE

Some candidates achieve composite scores on the CIRA exam that are only a point/a few points lower than the top three. Therefore, the Distinguished Performance Awards were created to recognize outstanding achievement of scorers that barely missed receiving medals. Distinguished Performance recipients that were present at the Annual Conference were (shown above, from left to right with Steve Darr) **John Rooney, CIRA,** Capstone Advisory Group LLC, Saddle Brook, New Jersey; **Brian Phillips, CIRA,** Amherst Partners, LLC, Birmingham, Michigan; **Stephen Spitzer, CIRA,** AlixPartners, LLP, New York, New York.

Not present at the conference: *Tungjun "John" Auyeung, Deloitte Financial Advisory Services LLP, New York, New York; Clifford Chen, CIRA, AlixPartners LLP, New York, New York; Derek Flanagan, CIRA, Argus Management Company, Chelmsford, Massachusetts.*

2012 MANNY KATTEN AWARD PRESENTED TO DANIEL ARMEL

Daniel Armel, CIRA (Baymark Strategies, Pasadena CA) was the recipient of the 2012 Manny Katten Award presented Thursday, June 7 at the 28th Annual Conference in San Francisco.

The Manny Katten Award is bestowed annually on an individual selected by AIRA's Board for demonstrating exceptional leadership, dedication and service to the bankruptcy, restructuring and turnaround field. Daniel Armel was chosen for this distinction based on his 40 years of leadership and service to the profession. His corporate advisory and financial restructuring experience includes ten years as a banker, eight years as the partner-in-charge of business reorganization services at Coopers & Lybrand, and almost 20 years as Chairman of Baymark Strategies. He has personally advised well over a hundred companies in strategic market positioning, corporate governance, finance, and business restructuring.

Mr. Armel is a Certified Insolvency and Restructuring Advisor (CIRA) and a member of AIRA's Board of Directors who has long been active in guiding and developing the Association. He played an important role in creating the CIRA program and AIRA's Toolbox courses, made significant contributions to the CDBV program, and served as AIRA President 1993-1996 and Chairman 1997-1998. Dan is also a Fellow and former Treasurer of the American College of Bankruptcy. A frequent lecturer and speaker on financial and corporate restructuring issues, he is nationally recognized for his viability assessments and valuation testimony.

Dan received his Bachelors degree from Ohio State and his MBA from the University of Michigan, and served as a lieutenant in the U.S. Army from 1968 to 1970. He and his wife Jane and their daughter Cristy reside in Pasadena, California.

Conference Highlights *continues on p. 10*

Conference Materials *continued from p. 9*

KEYNOTE SPEAKERS

Tomas Castrejon, *Director in the PwC Cyber Investigations* practice gave a keynote address on cyber terrorism and security on Thursday morning.

Craig Hall and **Ambassador Kathryn Hall** *of HALL Winery* graciously spoke at the AIRA Annual Banquet and Awards dinner on Thursday evening.

Patrick J. O'Keefe, *Director of Economic Research with J.H. Cohn,* LLP gives an economic update during Friday's luncheon.

BOARD OF DIRECTOR SERVICE

Farley Lee, CIRA, Senior Vice President with Deloitte CRG in San Francisco receives the award for service on the AIRA Board of Directors. Mr. Lee served on the AIRA Board of Directors from 2005-2011.

JOURNAL AWARDS

Prof. Baxter Dunaway (at right) of San Luis Obispo, CA was honored for his Bankruptcy Cases section and his contribution to every issue of the *AIRA Journal* since its inception.

Forrest Lewis with Plante & Moran in East Lansing, MI received an award for his significant contributions to *AIRA Journal*'s Bankruptcy Taxes section.

CO-CHAIRS

Thank you to this year's conference co-chairs who worked hard all year coordinating speakers, panels and topics.

Left: Co-Chair **Brian Choe, CIRA,** *Alvarez & Marsal, LLC.*

Right: Co-Chair **Matthew Pakkala, CIRA,** *FTI Consulting, Inc.*

SOCIAL ACTIVITIES

San Francisco social activities were a big hit. The activities offered included a golf outing at the Presidio Golf Course, (golf sponsor, **AlixPartners**; drink cart sponsor, **Burr & Forman LLP**); a RocketBoat tour of San Francisco Bay; a gourmet chocolate walk; Giants vs. Rangers baseball game (sponsored by **PCG Consultants**); an excursion to Napa Valley (sponsored by **BMC Group, Inc.**); and a 5k run/walk to the Embarcadero (sponsored by **ArentFox**).

Winning golf team: **Duncan Bourne, CIRA**; **Bernadette Norrington, CIRA**; **Brian Phillips, CIRA**; **Charles Goldstein, CIRA**

A great day was had by all on Saturday's wine tour sponsored by **BMC Group, Inc**. Here, the group is pictured at Silver Oak Winery in beautiful Napa Valley.

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EVALUATION COMMENTS

"Great city, hotel, topics and program"

"This was the best AIRA conference I have ever attended. Consistently good speakers and topics."

"Very educational conference."

"Perhaps the best conference in the U.S. Well-planned and well-executed."

Bankruptcy Taxes

Forrest Lewis, CPA
Plante & Moran PLLC

BANKRUPTCY COURT UPHOLDS KANSAS STATE EXEMPTION APPLYING ONLY TO FEDERAL BANKRUPTCY CASES

In a recent long and thorough opinion a Kansas bankruptcy judge upheld a 2011 state statute exempting federal and state earned income tax credits from a federal bankruptcy estate though those exemptions would not apply to debtors outside bankruptcy. The peculiarity of state exemptions solely for federal bankruptcy purposes and not applying to creditors outside of bankruptcy is becoming a national issue, e.g. California and Michigan have similar controversial statutes. This case drew a lot of attention from the Kansas Attorney General in support of the exemption and many amicus briefs from Kansas trustees attacking the exemption from many angles. The court probably took pains to explain its position on all issues because there were many similar cases in the pipeline, as it noted. *In re Dustin Westby, Brandi Westby, Debtors*., U.S. Bankruptcy Court, D. Kansas, 2012-1 U.S.T.C. ¶50,296 (Apr. 4, 2012).

Facts

On June 22, 2011, Debtors Dustin and Brandy Westby filed a voluntary Chapter 7 petition and elected to claim the state exemptions from federal bankruptcy instead of the federal bankruptcy exemptions including an exemption for "earned income tax credits" under a recently enacted Kansas statue. The Westbys' Schedule C claimed as exempt the "Earned Income Credit" with a current value of "Unknown." The Westby's filed their 2011 tax returns on March 5, 2012 and received a total federal refund of $6,702 of which the federal EIC was $5,751 and a total state refund of $1,490 of which the state EIC was $1,035.

The Kansas statute which became effective on April 14, 2011 read as follows:

> Section 1. An individual debtor *under the federal bankruptcy reform act of 1978* (11 U.S.C. §101 et seq.), may exempt the debtor's right to receive tax credits allowed pursuant to section 32 of the federal internal revenue code of 1986, as amended, and K.S.A. 2010 Supp. 79-32,205, and amendments thereto. An exemption pursuant to this section shall not exceed the maximum credit allowed to the debtor under section 32 of the federal internal revenue code of 1986, as amended, for one tax year. Nothing in this section shall be construed to limit the right of offset, attachment or other process with respect to the earned income tax credit for the payment of child support or spousal maintenance. [emphasis added]

Holdings

The court ruled in favor of the debtors on all issues and they were able to exempt the amount of the federal and state EIC from their federal bankruptcy estate. It concluded married debtors were entitled to exempt both the federal and state earned income tax credit (EIC) from their bankruptcy estate under state (Kansas) law because they opted out of the federal exemptions. Therefore, a state debtor may exempt from the estate those state or local law exemptions available as of the filing date of the bankruptcy petition.

Among the many important or interesting issues were these:

- The bankruptcy trustee's argument that the state exemption was unconstitutional based on the Uniformity or the Supremacy clause was rejected. The Uniformity Clause did not invalidate the state statute because it applied equally to all state debtors in bankruptcy. The Supreme Court has indicated that there is no Uniformity Clause violation as long as a state statute is not in conflict with federal bankruptcy law. The state statute did not conflict with federal bankruptcy law because Congress expressly granted states the power to enact exemption schemes; thus, there was no implied preemption of the state's law.
- On the issue of the "bankruptcy only" exemption, the court held that a review of cases in other states indicated that some were upheld and some denied. This court said that the view of the Supreme Court decisions on the Uniformity Clause show it has never been the basis for invalidating a *state* bankruptcy statute, it has only caused invalidation of a *federal* bankruptcy statute when the enactment singled out an individual debtor.
- The language of the exemption limiting the maximum credit allowed to the debtor under the EIC for one tax year did not conflict with Internal Revenue Code Sec. 6402 because if a debtor had no right to receive EIC as a refund as a result of an offset then no refund was available to which the exemption could apply.
- Many of the trustees' arguments asserted that the refunds had to be included in the bankruptcy estate but the court replied that the refunds were included in the estate; they were just subject of a valid state exemption.
- The Trustee made one alternative argument that the exemption would have to be prorated for 2011 since the statute was not in effect for the entire year citing *Barowsky v. Serelson*. The court ruled that the Kansas statute explicitly exempts the "maximum credit" for "one tax year." Therefore, a pro rata division would not be appropriate.
- One of the most interesting rulings was on the character of the refund. One amicus trustee argued that the exemption is ineffectual because there is no way to determine what portion of the total tax refund is attributable to the EIC and not to some other tax credit (or deduction). The court said the Tenth Circuit BAP was recently asked to similarly interpret the Colorado exemption of the "full amount of any federal or state income tax refund attributed to an earned income tax credit or a child tax credit." Acknowledging Colorado's liberal interpretation of exemption laws for the benefit of debtors, the BAP defined the word "attribute" to exempt "that part of the refund that is caused or brought about by the child tax credit. Thus, the Kansas refunds were held to be made up of the EIC to the extent the EIC equaled or exceeded the refund.

Commentary

This bankruptcy court ruling is very favorable to the debtors electing the Kansas state exemptions in lieu of the federal bankruptcy exemptions, especially in view of the many objections raised. Because of the illogical nature of one set of state exemptions existing for debtors in bankruptcy and another set for those outside of bankruptcy, we are sure to hear more on this issue as time goes on.

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

INTERESTING REORGANIZATION RULING: TAXPAYER SALVAGES SOME NOL CARRYFORWARD

The Internal Revenue Service recently granted a favorable ruling in an interesting reorganization case whose facts represent trends in modern corporate structuring. The reorganized corporation in the ruling managed to salvage and optimize some of their net operating loss carryforward under Internal Revenue Code Section 382(l)(6) as they emerged from Chapter 11. Apparently the taxpayer originally applied for the ruling on July 21, 2009 but IRS did not release Letter Ruling 201208002 until February 29, 2012 which indicates there was a lot of negotiation between the taxpayer and the IRS.

Corporate structure

The publicly traded corporation in the ruling operates a business through a chain of partnerships and single member limited liability companies which are treated as "disregarded entities" for tax purposes, all of whom filed for bankruptcy protection. While 20 years ago such a corporation would have operated through tiers of subsidiary corporations for legal protection purposes, it is increasingly common that this is accomplished with limited partnerships and single member LLCs. In fact most corporate groups now consist of a mix of subsidiary corporations and LLCs, but in the ruling the entire substructure apparently consisted of partnerships and LLCs. A group of corporations filing a consolidated tax return under federal rules and a structure of pass-through entities such as partnerships and disregarded LLCs can achieve roughly the same "consolidated" tax treatment where profits of some units can be offset by losses of others and intercompany transactions generally do not cause taxable income.

Falling into 382(l)(6) treatment

In Chapter 11 reorganizations it is common that there are substantial changes in the ownership of the debtor entities. This case is typical as old equity holders received nothing for cancellation of their stock and new stock will be issued to some creditors. If a debtor corporation has valuable net operating loss carryforwards which may reduce future income taxes and there is a change of ownership, Internal Revenue Code Section 382 generally calls for placing the loss carryforwards on an "amortization" method which can severely limit their usefulness. The definition of what constitutes a change of ownership for purposes of this section is extremely complicated but that definition was not really at issue in the ruling as it is one of the fact stipulations of the tax payer and for simplicity we will just say that a change in stock ownership of more than 50% triggers the adverse rules of Section 382.

For bankruptcy and receivership cases, there are some favorable sub-rules which create two alternate paths for maximizing benefit of loss carryforwards, Sections 382(l)(5) which treats creditors as pre-existing shareholders and can result in a conclusion that no change of ownership took place and 382(l)(6) in which the taxpayer is put on an amortization method but it can result in higher annual loss deductions than under the normal 382 rules. See the examples below. In the ruling the taxpayer will fall under the 382(l)(6) rule with a favorable determination of the amount of the annual amortization. [Actually, 382(l)(5) is the general rule for a corporation in bankruptcy under the statute but a taxpayer can elect out of it and choose to fall into 382(l)(6).]

In the ruling the debtor entity was undergoing a reorganization which qualified as a "Type G" bankruptcy reorganization for tax purposes meaning that at least some historical equity or security holders would receive stock or securities in the emerging entity. The ruling does not really pass on the bona fides of the Type G, it is just taken as a representation of the taxpayer. The taxpayer also represented right from the beginning that there would be a change of ownership for tax purposes and the emerging entity would be subject to the loss carryforward limitations of Section 382. [The ruling does not explain why the debtor did not qualify for 382(l)(5) treatment, perhaps it was because there was too much trading in debtor securities and they could not establish that those surrendering debt for new stock had held the debt 18 months as required. The fact that it took nearly three years to obtain the ruling makes you wonder if the taxpayer did not start off seeking 382(l)(5) treatment but could not get it.-- FL]

Turning to 382(l)(6) which will govern this case, the key to optimizing the loss carryforwards under that provision is maximizing the value of the corporation *immediately after* the change in ownership. When Section 382 applies, an annual loss limit is generally computed based on the value of the corporation immediately before the change multiplied by the IRS interest rate (applicable federal rate). Here is an example of the normal application of 382 outside the bankruptcy/receivership context:

> Example 1: The stock of Loser Corp., which has $20 million of net operating loss carryforwards, is sold for $3 million at a time when the IRS rate of interest is 4%. The primary annual limitation on use of the loss carryforward is $120,000 ($3,000,000 x .04).

However, in a Title 11 or receivership case, 382(l)(6) applies and works this way:

> Example 2: Debtor Corp. which has $20 million of net operating loss carryforwards undergoes a reorganization in Chapter 11. Immediately before the reorganization Debtor Corp. has a balance sheet deficit of $10 million but in the reorganization, $15 million of Newco. stock is issued in exchanged for debt which brings equity to a positive $5 million *immediately after* the change and we will assume for this example that is also the new fair market value of the company. As above we assume the IRS rate of interest is 4%. The primary annual limitation on use of the loss carryforward is $200,000 ($5,000,000 x .04).

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Bankruptcy Taxes *continued from p. 13*

The debt for stock exchange

The Joint Plan of Reorganization contained some interesting features all of which are apparently blessed in the ruling. [Though the ruling does not opine on the Type G per se, it has the following specific discussion of the exchange and the IRS will generally take exception to any assumed fact which would be disqualifying for the reorganization.] The important point is that where new stock is issued for old debt, it is counted toward the new equity value after the change in ownership:

(i) The notes and bank debt of certain of the Disregarded Entities will remain outstanding and will be reinstated;

(ii) Some holders of notes issued by Disregarded Entity 4 will exchange their old notes for new notes issued by Disregarded Entity 4. Those holders of notes issued by Disregarded Entity 4 who chose not to participate in the exchange of old notes for new notes, can exchange their old notes for cash. The surrender of notes issued by Disregarded Entity 4 in exchange for new notes issued by Disregarded Entity 4 and/or cash will be referred to as the "Notes Exchange";

(iii) Holders of notes issued by Disregarded Entity 3 will receive shares of Taxpayer's new Class A common stock, and certain holders will also receive Rights to purchase additional shares of Taxpayer's new Class A common stock, upon the Debtors' emergence from bankruptcy, in exchange for cash;

(iv) Holders of notes issued by Disregarded Entity 1 and Disregarded Entity 2 will receive warrants to purchase shares of Taxpayer's new Class A common stock;

(v) Holders of convertible notes issued by Taxpayer will receive cash and Taxpayer's new preferred stock;

(vi) Taxpayer's existing common stock will be cancelled; and

(vii) Trade creditors will be paid in full.

Certain noteholders agreed to subscribe for their respective pro rata portions of the Rights offering, and have, in addition, agreed to subscribe for a pro rata portion of any Rights that are not purchased by other holders of Disregarded Entity 3 notes in the Rights offering (the "Excess Backstop"). These noteholders who have committed to participate in the Excess Backstop will be offered the option to purchase a pro rata portion of additional shares of Taxpayer's new Class A common stock, at the same price at which shares of the new Class A common stock will be offered in the Rights offering.

The IRS ruling

The most important conclusions that IRS makes are:

1. The transaction qualifies for treatment under Section 382(l)(6).
2. The value of the company for purposes of computing the annual loss limitation will include new stock issued in exchange for debt (favorable)
3. Stock sold pursuant to the Rights Offering will *not* be included in valuing the company for the loss limitation (unfavorable, but to be expected)

This ruling provides an interesting insight into the details of 382(l)(6) played out in our modern context of LLCs and partnerships as corporate subsidiaries.

IRS FINALIZES PARTNERSHIP EQUITY FOR DEBT EXCHANGE RULES

One of the standard strategies for restructuring a troubled corporation or partnership, either in or out of bankruptcy, is to issue equity interests in exchange for debt canceled. At one time there was a general stock-for-debt, partnership-equity-for-debt favorable rule in which the transaction was not taxable. In the last 20 years, Congress has repealed those favorable rules and replaced them with rules requiring the equity interest to have a fair market value equal to that of the debt canceled or the difference is characterized as cancellation of debt (COD) income for the debtor. [IRC Section 108(e)(8)]. The Internal Revenue Service has recently finalized regulations on the partnership side of that equation calling for recognition of COD income by the pre-existing partners when a partnership creditor is issued a partnership equity interest in satisfaction of indebtedness when the equity interest has a value less than the amount of the debt. [T.D. 9557, Reg. 1.108-8]. Also certain clarifications were made to treatment of the exchange under Section 721 and the installment sale rules (see below).

The new regulation on the exchange of partnership equity for debt has detailed rules which help clarify the valuation issues but in closely held partnership situations, valuation will still be very difficult. The general rule is that for purposes of determining COD income of a debtor partnership, the partnership shall be treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the interest transferred to the creditor. Generally, the amount by which the indebtedness exceeds the fair market value of the partnership interest transferred is the amount of COD income required to be included in the distributive shares of the partners that were partners in the debtor partnership immediately before the discharge.

Because it may be easier to establish a liquidation value by analysis of the partnership's balance sheet rather than come up with some sort of bid-and-asked market valuation, the proposed regulations allow use of a liquidation value approach if four requirements are satisfied (liquidation value safe harbor). For this purpose, liquidation value equals the amount of cash that the creditor would receive with respect to the equity interest if, immediately after the transfer, the partnership sold all of its assets (including goodwill, going concern value, and any other intangibles) for cash equal to the fair market value of those assets, and then liquidated.

The four conditions of the liquidation value safe harbor in the proposed regulations are that

(i) the debtor partnership determines and maintains capital accounts of its partners in accordance with the capital accounting rules of Section 704

(ii) all parties, the creditor, debtor partnership, and its partners treat the fair market value of the indebtedness as being equal to the liquidation value of the debt-for-equity interest for purposes of determining the tax consequences of the debt-for-equity exchange (consistency requirement);

(iii) the debt-for-equity exchange is an arm's-length transaction (arm's-length requirement); and

(iv) subsequent to the debt-for-equity exchange, neither the partnership redeems nor any person related to the partnership purchases the debt-for-equity interest as part of a plan at the time of the exchange which has as a principal purpose the avoidance of COD income by the partnership (anti-abuse provision).

If these requirements are not satisfied, all of the facts and circumstances are considered in determining the fair market value of the debt-for-equity interest for purposes of applying section 108(e)(8).

The final regulations also address the application of the liquidation value safe harbor rule to a partnership (upper-tier partnership) that directly or indirectly owns an interest in one or more partnerships (lower-tier partnership(s)). The final regulations provide that, with respect to interests held in one or more lower-tier partnerships, the liquidation value of an interest in an upper-tier partnership is determined by taking into account the liquidation value of such lower-tier partnership interest.

Significance of COD income

Since partnerships are basically pass-through entities, any COD income recognized by the partnership will be allocated to the pre-existing partners for the year of the equity for debt exchange. Generally COD income is taxable to the individual partners but the usual Section 108 exceptions apply. The two most common of those exceptions are where the partner (not the partnership) has filed a petition in bankruptcy or where the partner is insolvent. When a partner qualifies for one of the exclusions under Section 108, the COD income is not taxable but certain favorable tax attribute carryforwards such as net operating losses or tax basis have to be reduced.

> Simplified example: ABC Partnership which has struggled financially has assets of $500,000 (at FMV), liabilities of $470,000 and equity of $30,000. Of the partners, who are all individuals and equal partners, A and B are solvent and C is insolvent. As part of a restructuring of ABC outside of bankruptcy, they approach unrelated individual creditor D who had lent them $100,000. D agrees to cancel the debt in exchange for a 70% interest in ABC Partnership. All parties agree to use the same valuations for tax purposes and to meet the other conditions listed above for the safe harbor valuation. After the exchange the assets are still $500,000 but the equity which would be distributed in a liquidation is now $130,000 [$30,000 + $100,000]. The partnership recognizes $9,000 of COD income since the equity has been increased by $100,000 but if a liquidation were to take place immediately, D would only receive $91,000 [$130,000 x 70%]. D takes the partnership interest with a carryover $100,000 basis from the loan. A, B and C each receive $3,000 of COD as their distributive share [$9,000/3]. A and B must include the $3,000 in taxable income. C is able to exclude the $3,000 of COD from taxable income under the insolvency exception but he must reduce certain favorable tax attributes by $3,000, possibly including his tax basis in his partnership interest.

Section 721 contribution to a partnership

IRS said since the general rule of Section 721 on contributions of assets in exchange for partnership interests is nonrecognition, no gain or loss would be recognized. There would be no deemed sale by the partnership of a "slice of its assets" nor would the creditor be allowed an immediate bad debt deduction corresponding to the COD income. The creditor will take a substituted basis in the partnership interest equal to the basis in the debt cancelled. During the public input period on the proposed regulations, some commenters had asked that a creditor be allowed a bad debt deduction equal to the COD to maintain symmetry of the transaction. The IRS decided not to allow that. IRS did carve out an exception from the nontaxable exchange rule, saying it will not apply to contribution of any receivable by a creditor for unpaid rent, royalty or interest. Generally those items will be taken into income by the creditor and the partnership will have an immediate tax deduction.

Contributed installment sale obligations triggered

When an installment sale is made for tax purposes, the gain is deferred and recognized ratably each year as the seller collects the principal of the note. In the case of an installment sale to a partnership, the creditor/seller holds a note from the partnership/buyer. If such a note is canceled by the creditor in exchange for a partnership equity interest, the IRS announced it is creating an adverse carve out which requires immediate recognition of the remaining gain on the underlying installment sale. This is consistent with the usual IRS position that where an installment obligation cannot be serviced according to its terms and the installment gain recognized year by year, the gain will be accelerated on the terminating event.

Commentary

The final regulations contain no real surprises. They align the tax treatment of partnership equity for debt exchanges with that of modification of debt instruments generally. Probably the only unfair provision is the asymmetry of the COD income recognition to the pre-existing partners but the creditor is not immediately allowed an equal bad debt deduction. However, the potential loss is preserved because the creditor's basis in the partnership interest will be higher than its initial fair market value. Thus the loss deduction is deferred at best.

TAX RULES ON PONZI LOSS DEDUCTIONS BY INDIVIDUAL INVESTORS

In his series on Ponzi schemes which began in the June/July, 2010 issue, Jack Williams did a great job of illuminating the financial workings of Ponzi schemes. This article addresses some of the tax rules allowing and disallowing tax deductions for Ponzi scheme losses by individual investors. There are two forms that an investor's loss to a Ponzi scheme can take:

Bankruptcy Taxes *continues on p. 16*

Bankruptcy Taxes *continued from p. 15*

1. The simple loss of principal and supposed accumulated income when the fraud becomes public and an investor discovers that little or no cash distribution of his investment will ever be made due to misappropriation.
2. A "clawback" when the investor is ordered to repay prior distributions of income to which he was told he was entitled by the scheme.

Fortunately, the Internal Revenue Service has been active in issuing pronouncements, most of them taxpayer-friendly, on deducting Ponzi scheme losses, especially in the case of the victims of Bernie Madoff. One issue is the character of the loss, whether capital or ordinary and another is the general three year statute of limitations for filing refund claims. Sometimes the loss does not come to light or the clawback is not ordered until years later.

The base case treatment in Rev. Rul. 2009-9

In a well written ruling probably issued to a Madoff victim, IRS explained the general tax treatment of losses of an individual from a Ponzi scheme:

1. The loss is deductible in the year of discovery
2. The amount of the loss is the amount invested plus taxable income reported on the investment minus cash distributions received and the amount of any reasonably expected recoveries
3. The loss is an itemized deduction as a theft loss, not a capital loss
4. The deduction is free of some of the unfavorable limits of itemized deductions including the "greater than 10% of AGI" requirement usually applied to casualty losses, the "reduction for 2% of AGI" usually applied to miscellaneous itemized deductions and the "reduction for 3% of AGI usually applied to high income individuals" (which has been suspended since 2005 anyway).
5. Apparently the Ponzi theft loss is deductible for computing alternative minimum tax which is not discussed in the ruling but is very beneficial.
6. The loss can contribute to a net operating loss which can be carried backward and forward
7. In the view of the IRS, certain mitigation of the statute of limitation provisions are not available for a simple, non-clawback loss situation, i.e. Secs. 1311 and 1341.

The Safe Harbor of Rev. Proc. 2009-20

In this IRS revenue procedure a Ponzi scheme loss is defined as a "specified fraudulent arrangement":

> A specified fraudulent arrangement is an arrangement in which (i) a party (the lead figure) receives cash or property from investors; (ii) purports to earn income for the investors; (iii) reports income amounts to the investors that are partially or wholly fictitious; (iv) makes payments, if any, of purported income or principal to some investors from amounts that other investors invested in the fraudulent arrangement; and (v) appropriates some or all of the investors' cash or property.

In order to use the safe harbor there must be a "qualified investor," essentially requiring that the investor had no prior knowledge of the fraud and the investment is not designed as a tax shelter. There are several requirements establishing the bona fides of the criminal activity of the lead figure:

> (1) The lead figure was charged by indictment or information under state or federal law with the commission of fraud, embezzlement or a similar crime that, if proven, would meet the definition of theft for federal tax purposes; or
>
> (2) The lead figure was the subject of a state or federal criminal complaint alleging the commission of one of the crimes described above, and either -
>
> > (a) The complaint alleged an admission by the lead figure, or the execution of an affidavit by that person admitting the crime; or
> >
> > (b) A receiver or trustee was appointed with respect to the arrangement or assets of the arrangement were frozen.

Benefits of proceeding under the safe harbor:

- The loss will be deductible as a theft loss in the year that one of the legal actions above is taken against the lead figure(s). This was later modified because some of the lead figures had died before they could be indicted, so the appointment of the receiver or trustee became sufficient in itself. [Rev. Proc. 2001-58]
- The calculation of the reduction of the loss for prospective recovery is simplified in the following way:
- (1) Multiply the amount of the qualified investment by—
- (a) 95 percent, for a qualified investor that *does not pursue* any potential third-party recovery; or
- (b) 75 percent, for a qualified investor that *is pursuing* or intends to pursue any potential third-party recovery; and
- (2) Subtract from this product the sum of any actual recovery and any potential insurance/SIPC recovery (to date).
- Why wouldn't you always use the safe harbor?:
- Not all taxpayers will qualify under the safe harbor. Recently IRS rejected a loss deduction under the safe harbor where the lead figure, who was still alive, had not yet been indicted. In such fact situations the taxpayer can only proceed under the general rules of Rev. Rul. 2009-9 and hope he can prove all the required elements of the deduction, especially the valuation elements.
- As mentioned above, the IRS takes the position that Sec. 1341 does not apply. That section of the tax law allows the taxpayer the best tax result comparing the tax rates in effect in the year of repayment versus those in effect in the year the bogus income was reported. Taxpayers may not agree with that position and may want to compute the tax benefit of the phantom income portion of their loss using that method.

The Revenue Procedure only allows an individual directly investing with the lead figure the benefits of the safe harbor. Anyone who

invests in a fund which invested with the lead figure cannot use this procedure although the fund itself can use the procedure. Depending on the tax status of such a fund as a pass-through or a tax paying entity, that could lead to a variety of resulting effects.

The safe harbor procedure specifies certain disclosures to be made on any tax return claiming the safe harbor benefits and requires the taxpayer to sign an affidavit as to certain facts and waiving certain optional ways of claiming the loss deduction.

The trickier question of clawbacks

Any taxpayer facing a clawback has an anomalous situation facing them. First, neither the 2009 revenue ruling nor the revenue procedure mention clawbacks. At least one attorney has written that he thinks any clawback payment should be a deductible loss although the safe harbor definition of "qualified investment" does not mention it nor seem to comprehend future additional payments or "investments." There is some authority that any payment made to settle a legal dispute cannot be made voluntarily but must be under compulsion or at least an arms-length compromise. Presumably most clawback payments will occur several years after the initial loss deduction was reported by the taxpayer. If the taxpayer filed under the safe harbor initially, should he submit the current loss deduction under the safe harbor procedure. Note that the safe harbor procedure required the taxpayer to waive his right to calculate the tax benefit under Sec. 1341 using the best tax rates. Is the taxpayer now foreclosed from computing the tax under Sec. 1341?

Conclusion

An individual taxpayer suffering a Ponzi scheme loss first has to decide whether to take the benefits of the safe harbor of Revenue Procedure 2009-20 or go it without the safe harbor which presumably raises the risk of audit or IRS adjustment to the deduction. A taxpayer facing a clawback should carefully consider the deductibility of any such payments and the availability of benefit under the Sec. 1341 tax computation. The Treasury Inspector General's office conducted a study of the claimed Ponzi scheme losses for 2008 and found what they called an 82% rate of nonqualifying losses but much of that was due to timing and incomplete documentation on the part of the taxpayer. No taxpayers were actually audited in that process but the Inspector General has called for IRS to tighten procedures surrounding Ponzi loss deductions.

Thanks to Grant Newton and Dennis Bean for their assistance with this article and to Attorney Richard Lehman for his insights.

NEW FORM 8937 REQUIRED FOR TRANSACTIONS WHICH AFFECT STOCK BASIS

In 2011 the Internal Revenue Service issued a new form, 8937, which "issuers" of stock and securities must file for any transactions which may affect tax basis (see examples below). This form is part of the new system of basis reporting by investment brokers and is intended to put stock and security holders as well as the IRS on notice as to transactions which may affect basis. It is related to the Form 1099-B as you send a copy to IRS and to the security owner. The form, Report of Organizational Actions Affecting Basis of Securities 8937, is relatively simple and is basically narrative in form but it does require an estimate of the percentage or dollar amount per share change caused by the transaction. The requirement applies to stock as well as bonds and notes. It governs both publicly held and privately held securities. Technically the form is due to be filed within 45 days after the transaction or January 15th following the calendar year if earlier.

Typical transactions or corporate actions requiring filing of the form:

- mergers
- acquisitions
- recapitalizations
- stock splits
- redemptions and distributions (not treated as dividends for income tax purposes)

Statutory exceptions—you don't have to file the form in the case of exempt recipients which include:

1. corporations (or entities treated as corporations for federal income tax purposes),
2. foreign holders,
3. tax-exempt organizations.

The regulations contain a major taxpayer-friendly provision which allows an issuer to meet both the IRS filing and providing to the security owner requirements by publishing Form 8937 on their website and maintaining that information for 10 years. In the case of S corporations, the issuer is allowed to report the basis changes as part of the K-1 reporting process in lieu of Form 8937.

While the regulations under Sec. 6045B do not seem to define "issuer" in the bankruptcy context, only the debtor corporation would seem to be an "issuer." While a liquidating trust is the successor in interest to the debtor corporation for certain tax purposes, at this point a liquidating trust is probably not considered an "issuer" with regard to stock or securities, so is not subject to Form 8937 filing.

It remains to be seen whether the IRS actively uses this form or simply considers it information the security holder should be using. It may be treated by IRS with the same neglect as related Form 966 Corporate Dissolution or Liquidation which Attorney Michael Cohen jokes is stored in that government warehouse next to the Ark of the Covenant in the last scene of Raiders of the Lost Ark. ■

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Bankruptcy Cases

Professor Baxter Dunaway

BANKRUPTCY

Tenth Circuit Court of Appeals

Does creditor need to produce original note to establish standing to lift stay and foreclose?

Under Colorado law and the Uniform Commercial Code creditor needs to produce original note to establish standing to lift automatic stay and foreclose. *In re Miller*, 666 F.3d 1255 (10th Cir. Feb 01, 2012) (NO. 11-1232).

After Deutsche Bank National Trust Company (Deutsche Bank) brought a foreclosure action against the home owned by appellants Mark Stanley Miller and Jamileh Miller and obtained an Order Authorizing Sale (OAS) from a Colorado court, the Millers filed a Chapter 13 bankruptcy petition. Upon the filing of their petition, an automatic stay entered, halting the foreclosure proceedings. *See* 11 U.S.C. § 362(a). Deutsche Bank obtained an order from the bankruptcy court relieving it from the stay to permit the foreclosure to continue. *See id.* § 362(d). The Tenth Circuit Bankruptcy Appellate Panel (BAP) affirmed the bankruptcy court's order granting Deutsche Bank relief from the automatic stay. The Millers now appeal from the BAP's order affirming relief from stay.

The issue before the Tenth Circuit was whether Deutsche Bank established that it was a "party in interest" entitled to seek and obtain relief from the stay. *See id.* Because the court concluded that Deutsche Bank did not meet its burden of proof on this issue, the court reversed the BAP's order and remanded for further proceedings.

Does Deutsche Bank have a "right to payment" from the Millers? In examining this question, the court began with the principle that "[w]ithin the context of a bankruptcy proceeding, state law governs the determination of property rights. The Court of Appeals therefore turned to Colorado law, in particular that state's version of the Uniform Commercial Code (U.C.C. or Code).

The court asked first how Colorado law would classify the Note signed by the Millers. Under Colorado law, a promise or order such as the Note is payable "to order" "if it is payable (i) to the order of an identified person or (ii) to an identified person or order." Colo.Rev.Stat. § 4–3–109(b). The Note at issue here is payable "to the order of Lender"— Lender is IndyMac Bank, F.S.B. Thus, the Note is payable to the "order" of IndyMac Bank under § 4–3–109(b). But "[a]n instrument payable to an identified person [such as IndyMac Bank] may become payable to bearer if it is indorsed in blank pursuant to section 4–3–205(b)." Colo. Rev.Stat. § 4–3–109(c). Section 4–3–205(b) provides that "[i]f an indorsement is made by the holder of an instrument and it is not a special indorsement, it is a 'blank indorsement.' When indorsed in blank, an instrument becomes payable to bearer and may be *negotiated by transfer of possession* alone until specifically indorsed." (emphasis added).

The U.C.C. identifies the requirements for "negotiation" of a note, that is, for "transfer of possession ... to a person who thereby becomes its holder." *Id.* § 4–3–201(a). This statute provides that "if an instrument is payable to an identified person, negotiation requires *transfer of possession* of the instrument and its indorsement by the holder." *Id.* § 4–3–201(b) (emphasis added). The Official Commentary to section 4–3–201 explains that negotiation "*always requires a change in possession of the instrument* because nobody can be a holder without possessing the instrument, either directly or through an agent." (emphasis added). Possession is an element designed to prevent two or more claimants from qualifying as holders who could take free of the other party's claim of ownership."With rare exceptions, those claiming to be holders have physical ownership of the instrument in question. In the case of bearer paper such as the Note, physical possession is essential because it constitutes proof of ownership and a consequent right to payment.

While Deutsche Bank has offered proof that IndyMac assigned the Note in blank, it elicited no proof that Deutsche Bank in fact obtained physical possession of the original Note from IndyMac, either voluntarily or otherwise. Under the U.C.C. requirements, Deutsche Bank has therefore failed to show that it is the current holder of the Note.

Colorado law does not limit enforcement of an obligation to a holder who received the instrument through negotiation. A note may also be enforced by a *transferee. See* Colo.Rev.Stat. § 4–3–203. "Transfer of an instrument, whether or not the transfer is a negotiation, vests in the transferee any right of the transferor to enforce the instrument." *Id.* § 4–3–203(b). But transfer requires delivery: "An instrument is transferred when it is *delivered* by a person other than its issuer for the purpose of giving to the person receiving delivery the right to enforce the instrument." *Id.* § 4–3–203(a) (emphasis added). "Delivery" with respect to an instrument "means voluntary transfer of possession" of the instrument. *Id.* § 4–1–201(b)(14). The court held that because Deutsche Bank has failed to prove transfer of possession of the original Note it has failed to establish its status as a transferee. 666 F.3d 1255, 1264. The court held that the evidence is insufficient to establish that Deutsche Bank is a "party in interest" entitled to seek relief from stay. The bankruptcy court therefore abused its discretion by granting Deutsche Bank relief from stay. 666 F.3d 1255, 1264.

COMMENT: Although the Tenth Circuit based its decision on the applicability of Colorado law, Colorado and all other states have adopted the Uniform Commercial Code. Thus this case is an important precedent in jurisdiction other than Colorado.

Seventh Circuit Court of Appeals

In "Single Asset" real estate chapter 11 bankruptcy case are treasury bonds the "Indubitable Equivalent" of Lien?

In "Single Asset" real estate chapter 11bankruptcy case, treasury bonds are not the "Indubitable Equivalent" of Lien. U.S.C. § 1129(b)(2)(A)(iii), *In re River East Plaza, LLC*, --- F.3d ----, 2012 WL 169760, 55 Bankr.Ct.Dec. 265 (7th Cir.(Ill.) Jan 19, 2012) (NO. 11-3263).

A "single real estate" asset, within the meaning of the Bankruptcy Code as that term is defined in 11 U.S.C.A. § 101(51B), is a nonresidential property, or a residential property containing five or more apartments or other residential units, "on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental thereto." 11 U.S.C. § 101(51B). The single asset in this case is a building called River East Plaza. LNV Corporation has a first mortgage on the building. LNV is owed $38.3 million but River East's building is currently valued at only $13.5 million. The building's owner and mortgagor, River East Plaza, LLC, defaulted on the mortgage and LNV promptly started foreclosure proceedings in state court, prevailed, and a foreclosure sale of the property was scheduled. Just hours before the sale was to occur, River East filed for bankruptcy under Chapter 11 and the filing automatically stayed the sale. 11 U.S.C. § 362(a)(4).

LNV is owed $38.3 million but River East's building is currently valued at only $13.5 million. So LNV's secured claim is undersecured, and an under-secured creditor who decides, as LNV has decided, to participate in his debtor's bankruptcy proceeding has a secured claim for the value of the collateral at the time of bankruptcy and an unsecured claim for the balance. 11 U.S.C. § 1111(b)(1)(A). But generally he can exchange his two claims for a single secured claim equal to the face amount of the unpaid balance of the mortgage. § 1111(b)(1)(B), (2). LNV made this choice, so instead of having a secured claim for $13.5 million and an unsecured claim for $24.8 million it has a secured claim for $38.3 million and no unsecured claim. --- F.3d ----, 2012 WL 169760, *3. The swap is attractive to a mortgagee who believes both that the property that secures his mortgage is undervalued and that the reorganized firm is likely to default again—which often happens: between a quarter and a third of all debtors who emerge from Chapter 11 with an approved plan of reorganization later re-enter Chapter 11 or have to restructure their debt.

Normally a mortgage lien remains a lien on the mortgaged property until the mortgage is paid off, even if the property is sold, because a lien runs with the property. But if the bankruptcy judge confirms a plan of reorganization that removes the lien of a participating creditor, the lien is gone. --- F.3d ----, 2012 WL 169760, *1. The creditor can try to protect himself against such a loss of lien by objecting to the plan, and his objection will block it (*see* 11 U.S.C. § 1129(a)(8)(A)) unless it can be crammed down his throat under one of the three subsections of 11 U.S.C. § 1129(b)(2)(A). Under (i), the reorganized debtor keeps the property and may be allowed to stretch out the repayment of the debt beyond the period allowed by the loan agreement, but the lien remains on the property until the debt is repaid. Under (ii), the debtor auctions the property free and clear of the mortgage but the creditor is allowed to "credit bid," meaning to offer at the auction, not cash, but instead a part or the whole of his claim, so that, for example, LNV could bid $20 million for River East's building just by reducing its claim from $38.3 million to $18.3 million. Under (iii), the lien is exchanged for an "indubitable equivalent." The last subsection is the one River East invoked in its proposed plan of reorganization—unsuccessfully. The bankruptcy judge rejected the plan, lifted the automatic stay, and dismissed the bankruptcy proceeding. River East seeks to avoid the requirement in a subsection (i) cramdown of maintaining the mortgage lien on the debtor's property by transferring LNV's lien to different collateral, also in the name of indubitable equivalence. River East's plan could not be confirmed because the substitute collateral that it proposed was not the "indubitable equivalent" of LNV's mortgage. --- F.3d ----, 2012 WL 169760, *2.

River East was unhappy with LNV's choice. Probably like LNV it expected the value of the building to appreciate and did not want to share that appreciation with its creditor. Or maybe, as it argues, prospective financiers of the reorganized firm wanted to have a senior lien on the building. River East wanted LNV out of there and decided to seek confirmation of a plan of reorganization that would replace the lien on the building with a lien on $13.5 million in substitute collateral, namely 30–year Treasury bonds that would be bought by an investor in the reorganized firm. At current interest rates, River East argued, the bonds would grow in value in 30 years through the magic of compound interest to $38.3 million, thus guaranteeing that LNV would be repaid in full. The substitute collateral would be equivalent to LNV's lien.

The bankruptcy judge rejected the plan. LNV is owed $38.3 million but River East's building is currently valued at only $13.5 million. LNV's secured claim is undersecured, and an under-secured creditor who decides, as LNV has decided, to participate in his debtor's bankruptcy proceeding has a secured claim for the value of the collateral at the time of bankruptcy and an unsecured claim for the balance. 11 U.S.C. § 1111(b)(1)(A). But generally he can exchange his two claims for a single secured claim equal to the face amount of the unpaid balance of the mortgage. § 1111(b)(1)(B). LNV made this choice, so instead of having a secured claim for $13.5 million and an unsecured claim for $24.8 million it has a secured claim for $38.3 million and no unsecured claim.

Had LNV not used 1111(b) to give up its unsecured claim in exchange for a larger secured claim, it would receive some fraction of its unsecured claim in the Chapter 11 proceeding, and would continue after the bankruptcy to have a $13.5 million claim secured by the building. The building would continue to be owned by the debtor if the latter had emerged from bankruptcy, having been permitted to reorganize. If the debtor later defaulted and the building was sold, LNV would realize a maximum of $13.5 million (the amount of its secured claim) from the sale, even if the

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Bankruptcy Cases *continued from p. 19*

building was sold for more. In contrast, given the 1111(b) swap, if the value of the building rose say to $20 million by the time the former debtor again defaulted, LNV, if allowed to foreclose, would realize all $20 million because his secured claim would exceed that amount. --- F.3d ----, 2012 WL 169760, *3.

The bankruptcy court found, and the Seventh Circuit agreed, that the proposed lien on Treasury bonds was not equivalent to a lien on real estate, which had the potential to appreciate. Given the market conditions, the building had every chance of appreciating in value, and if it did and debtor defaulted again, the mortgagee would have an intact lien on the property and would be able to foreclose and become the owner of the collateral and the recipient of the appreciated value. Waiting 30 years to get paid on Treasury bonds was not the same thing. Treasury bonds, moreover, while they do not have a default risk, are at risk of losing value to inflation. In the end, the court found that the two forms of collateral had such different risk profiles that they could not be considered equivalent. 2012 NO. 3 BSV-BCA 6; --- F.3d ----, 2012 WL 169760, *7.

Ninth Circuit Court of Appeals

Is a debtor-subsidiary that was part of a network of over 50 subsidiaries which, together with the debtor-parent, each filed Chapter 11 petitions that were not substantively consolidated, subject to the single asset real estate provisions of the Bankruptcy Code?

A debtor-subsidiary that was part of a network of over 50 subsidiaries which, together with the debtor-parent, each filed Chapter 11 petitions that were not substantively consolidated, was subject to the single asset real estate provisions of the Bankruptcy Code, the Ninth Circuit Court of Appeals ruled. *In re Meruelo Maddux Properties, Inc.*, --- F.3d ----, 2012 WL 248167, *3 (9th Cir. (Cal.) Jan 27, 2012) (NO. 10-56128).

Although debtor subsidiary was part of network of over 50 subsidiaries that together with debtor parent each filed Chapter 11 bankruptcy petitions that were not substantively consolidated, subsidiary was subject to single asset real estate provisions of Bankruptcy Code that did not exempt whole business enterprises, thus allowing subsidiary's secured creditor relief from automatic stay, since subsidiary's 92-unit apartment complex was single property that generated all or substantially all of subsidiary's gross "income," which did not include income from parent or sister subsidiaries absent substantive consolidation or any evidence that enterprise's consolidated management team and centralized cash management system provided any funds or assets to subsidiary that qualified as income, and subsidiary's only business activities involved operating and collecting rents from apartment complex. 11 U.S.C.A. §§ 101(51B), 362(d)(3). *In re Meruelo Maddux Properties, Inc.*, --- F.3d ----, 2012 WL 248167, *3 (9th Cir.(Cal.) Jan 27, 2012) (NO. 10-56128).

To determine whether the subsidiary was a single asset real estate debtor, the Court of Appeals looked to the plain language of the Bankruptcy Code. Under 11 U.S.C.A. § 101(51B), single asset real estate "is defined as real property that meets three elements: that the property be, first, 'a single property or project, other than residential real property with fewer than [four] residential units'; second, that the property 'generates substantially all of the gross income of a debtor who is not a family farmer'; and, third, that 'no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental thereto.'" The purpose of a single asset real estate determination is to allow for relief from the automatic stay to any creditor whose claim is secured by single asset real estate, as provided in 11 U.S.C.A. § 362(d)(3).. 02-8-12 WESTBKRN 4.

Sixth Circuit Court of Appeals

Under Michigan law, is assignee of forged mortgage entitled to equitable mortgage?

Appellants U.S. National Bank and Saxon Mortgage Services, Inc., appealed the order of the district court overturning a judgment of the bankruptcy court granting them an equitable mortgage on property owned by Debtors Daniel and Sheryl Sutter. The Sixth Circuit AFFIRMED the judgment of the district court. *In re Sutter*, 665 F.3d 722 (6th Cir. (Mich.) Jan 03, 2012) (NO. 10-1656). Under Michigan law, assignee of forged mortgage was not entitled to equitable mortgage due to unclean hands.

Seventh Circuit Court of Appeals

Under § 363(m), is a creditor's appeal from an order sustaining an objection to its claim moot because the creditor did not obtain a stay pending appeal from the sale of debtor's property under § 363 and did not file a notice of appeal challenging the plan's approval?

Creditor appealed bankruptcy court's disallowance of his claim in debtor limited liability company's (LLC's) bankruptcy proceeding, which alleged that creditor was entitled to percentage of LLC's profits under written agreement. Creditor appealed. After bankruptcy court confirmed joint liquidation plan proposed by debtor and its largest secured creditor, pursuant to which debtor's sole asset was sold at auction, debtor and secured creditor moved to dismiss appeal as moot. The United States District Court for the Northern District of Illinois, 2011 WL 1357144, granted motion. Creditor appealed. Holding: The Seventh Circuit Court of Appeals held that creditor's appeal of bankruptcy court's disallowance of claim was moot. *In re River West Plaza-Chicago, LLC*, 664 F.3d 668 (7th Cir. 2011).

COMMENT: Courts take a dim view of attempts to end run the appeal and stay requirements of § 363(m). Accordingly, courts hearing appeals from sale orders—which the creditor never appealed—reject attempts to attack the distribution of proceeds when no stay was obtained. ■

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Bankruptcy Valuation

Kenji Mochizuku, CIRA
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Local Governments in Distress: Recent Filings and Review of Resources

Facing a $45-million budget shortfall and the prospect of not being able to pay city workers, representatives of the City of San Bernardino, California, voted on July 10, 2012, to file municipal bankruptcy—the third California city to do so in recent weeks. On July 2, 2012, the council leadership of the Town of Mammoth Lakes, California, voted to approve a Chapter 9 bankruptcy filing. The City of Stockton, California, on June 28 became the most populous U.S. city to file for Chapter 9 municipal bankruptcy protection.

In anticipation of more filings and continued distress among struggling municipalities, AIRA will host the webinar "Corporate and Municipal Credit Analysis: A Discussion of Techniques Used by Rating Agencies" on Tuesday, July 31 at 1:00 pm ET / 10:00 am PT. Credit analysis is the primary tool of bond insurers and credit rating agencies such as Standard & Poor's (S&P), Moody's Investor Service, and Fitch Ratings. The comprehensive quantitative and qualitative approach of credit analysis in evaluating companies and municipalities can serve as a useful framework for bankruptcy and restructuring professionals in valuing and assessing the viability of distressed entities. Registration for the webinar is available online at www.aira.org.

AIRA recently presented three other webinars in this subject area, in February-April 2012, dealing with legal, financial, and accounting aspects of municipal distress and bankruptcy. Recorded versions of these presentations are available as resources for reference and continuing professional education at www.aira.org.

Review and Summary of Resources on Distressed Municipals

The definition of "municipality" under Chapter 9 includes not only local governments, but also hospitals, schools, bridge authorities, highway authorities, gas authorities, public improvement districts, etc.[1] These categories include many clients served by professionals that are members of AIRA including CIRAs and CDBVs. The comments below continue a review and summary of useful resources relevant to troubled municipalities and their advisors (see the author's last column,[2] *AIRA Journal*, 25:6, p.5).

1) *Investing in the High Yield Municipal Market: How to Profit from the Current Municipal Credit Crisis and Earn Attractive Tax-Exempt Interest Income*, by Triet Nguyen, published July 10, 2012 by John Wiley & Sons, Inc. / Bloomberg Pres.[3] An advance copy of the book reveals a title written in a conversational, non-academic tone which succeeds in covering a wide range of topics in a comprehensive manner, including quantitative aspects. This is the first book published on the topic of high yield municipal bonds because until 2007-2008 the extent of distress and bankruptcy in the municipal market was limited. Both the basics and history of high yield municipal bonds are discussed. The investment topics include a comparison to other asset classes, a summary of the bond default record, a look at distressed bonds, an analysis of two case studies, and a discussion of high yield investing with the decline of bond insurers.

Roughly one third of the book was written by contributing authors, and those five chapters and one appendix cover the following topics: investing in individual high yield municipal bonds; managing municipal bond defaults and bankruptcies of the municipal issuers; a summary of five common types of high yield municipal bonds (corporate-backed, hospital, toll road, housing, and Continuing Care Retirement Communities (CCRC)); a discussion of two special types of high yield municipal bonds (tobacco settlement, land-secured); an exploration in two growing sectors of high yield municipal bonds (charter school, native American gaming); and a review of the legislative and regulatory issues concerning the municipal bond market (esp. the Dodd-Frank Act and the Volcker Rule). This book would help provide a deeper understanding of the bonds issued by clients and can assist efforts of bankruptcy / restructuring professionals.

[Editor's note: Kenji Mochizuki authored the chapter on municipal defaults and bankruptcies and the appendix. This book is available through AIRA Book Store.]

2) "Fiscal Distress: Prescriptions for Good Management in Bad Times"—a 16-page report published in 2003 by ICMA and written by Thomas Sommer.[4] In the previous recession, roughly between 2002 and 2003 after the dot com bubble collapsed, ICMA responded to local government requests for information on how to cope with fiscal crisis by interviewing county managers and city managers to discover how they were coping with a down economy and its impact on the local level. This report is a result of those interviews conducted in the summer of 2003.

The core of this publication is a "collection of seven case studies illustrating strategies for reducing costs, maintaining service levels in the face of financial crisis, and winning citizen approval for tax and fee increases"[5]: 1) the redefining of priorities by the City of Fayetteville, North Carolina; 2) the four-point plan to survive recession by the City of Fremont, California; 3) the investing

***Bankruptcy Valuation** continues on p. 22*

1 The Administrative Office of the U.S. Courts, Chapter 9 Municipality Bankruptcy, Eligibility http://www.uscourts.gov/federalcourts/bankruptcy/bankruptcybasics/Chapter9.aspx

2 https://www.aira.org/pdf/journal/february-march-2012.pdf

3 Nguyen, Triet. *Investing in the High Yield Municipal Market: How to Profit from the Current Municipal Credit Crisis and Earn Attractive Tax-Exempt Interest Income*. (Hoboken, New Jersey: John Wiley & Sons, Inc., 2012). http://www.wiley.com/WileyCDA/WileyTitle/productCd-1118175476.html

4 Sommer, Thomas. Fiscal distress: Prescriptions for good management in bad times. Volume 35, Number 8, August 2003. (Washington, D.C.: International City/County Management Association, 2003). http://bookstore.icma.org/Fiscal_Distress_Prescriptions_P1057.cfm?UserID=9182306&jsessionid=4e305a6f5350b93a7677

5 *Ibid*.

Bankruptcy Valuation *continued from p. 21*

in technology in the City of Valdosta, Georgia; 4) the regional approach to cutting costs in the City of Shoreline, Washington and the City of Federal Way, Washington; 5) the Brownfields redevelopment to spur economic growth in the City of Sterling, Illinois; 6) the business plan to guide fiscal decisions for the City of Coral Springs, Florida; and 7) the public outreach process of the City of Toppenish, Washington.

This report begins with a section entitled, "Ten Prescriptions for Challenging Budget Times" written by Kevin C. Duggan, city manager of the City of Mountain View, California, who worked through two severe economic downturns. Because of the focus on creative solutions as well as best practices for addressing serious fiscal shortfalls that were considered in the previous recession, this practical title is a worthy read for any advisor who is seeking past examples to develop feasible options for a current client.

3) "Budget Shortfalls: How Some Local Governments Are Responding (Special Data Issue)"—a 34 page report published in 2004 by the ICMA.[6] This title analyzes the results of one section from ICMA's 2003 survey entitled, "Reinventing Government: Implementation at the Local Level" which was mailed to the Chief Administrative Officers in municipalities with populations of 10,000 and above, and achieved a 33.3% response rate of the 3,215 municipalities surveyed.[7]

Survey respondents considered nine options for dealing with budget shortfalls, and were to identify which ones they "considered" and which ones they implemented: sharing services, reducing service delivery, eliminating delivery of non-required services, increasing taxes, adding or increasing user fees, rescinding previously approved capital expenditures, freezing vacant positions, using reserve funds, or identifying a non-traditional source of revenue.

The least implemented measure was identifying a non-traditional source of revenue. The bulk of this report discusses all nine options that were implemented, and it is worth reading this title in order to learn how often these local governments changed user fees, increased taxes, froze vacant positions, changed service delivery, or rescinded previously approved capital expenditures. The usefulness of this title is to provide quantitative support for any recommendation that an advisor would provide to a local government client, where this data is classified by population size, geographic region, metro status, and form of government. The identity of every local government that implemented each of these nine options is disclosed, and the reader is even "encouraged to contact them to learn more about their decisions and the effect those decisions have had on the community."[8]

4) "Budgeting for Outcomes: Better Results for the Price of Government"—a 24-page report published in 2004 by the ICMA, written by David Osborne and Peter Hutchinson, and adapted from the book, *The Price of Government: Getting the Results We Need in an Age of Permanent Fiscal Crisis*.[9] This report discusses how for half a century, Americans have been willing to commit only about 6 to 7 cents per dollar of annual personal income to buy services from their local governments (compared to 7 to 9 cents for state government services and 20 to 25 cents for Federal government services). While this "price of government" is fixed, the costs of local government are not, resulting in a permanent fiscal crisis exacerbated by traditional budgeting that only provides for the status quo and permits the majority of spending to escape examination.[10] According to the authors, the failure of traditional budgeting is due to this approach beginning with the question, "How much will it cost to keep doing what we've been doing in the way we have always done it with the results we have always gotten?"—where the answer is always, "More."[11]

Using as examples the State of Washington, the County of Snohomish, Washington, and the City of Spokane, Washington, the authors posit an alternative approach to traditional budgeting they call "budgeting for outcomes" that begins instead with determining the results that citizens want, not the programs that are already funded.[12] The local government's five key budgeting challenges are developed from five key questions: 1) Is the real problem short or long term? 2) How much are citizens willing to pay? 3) What results do citizens want for their money? 4) How much will the state pay to produce each of these results? and 5) How best can that money be spent to achieve each of the core results?

The authors' framework then proceeds to set the price of local government, to set the priorities of government, to set the price of each priority, to develop a purchasing plan for each priority, to solicit offers from providers to deliver the desired results, and then to negotiate performance agreements with the chosen providers. Accompanied by many detailed exhibits, this report succeeds in illustrating how local governments might provide residents what they really want and need from government at a price they are willing to pay. Thus, this robustly developed framework and amply illustrated report would benefit any reader seeking a didactic approach to assisting a client's budgeting process. ■

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6 Moulder, Evelina. Budgeting shortfalls: How some local governments are responding, Special Data Issue no. 5 (2003) (Washington, D.C.: International City/County Management Association, 2004). http://bookstore.icma.org/Budget_Shortfalls_How_Some_Lo_P1135.cfm?UserID=9182306&jsessionid=4e305a6f5350b93a7677

7 http://bookstore.icma.org/Reinventing_Local_Government_2_P1486C93.cfm

8 Moulder, p. 7.

9 Osborne, David, and Hutchinson, Peter. Budgeting for outcomes: Better results for the price of government. Volume 36, Number 11, November 2004. (Washington, D.C.: International City/County Management Association, 2004).

10 *Ibid*., p. 1.

11 *Ibid*., p. 4.

12 *Ibid.*

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