AIRA Journal

News from the Association of Insolvency and Restructuring Advisors Volume 22, Number 5 December/January 2009

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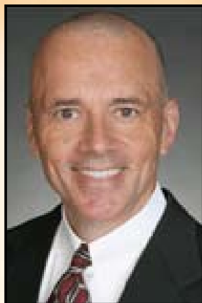
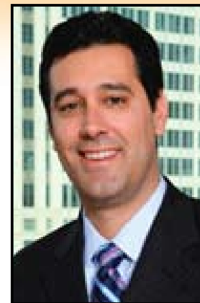


Overview of Issues Related to Professional Retention in Bankruptcy Cases



Gregory M. Gordon and Daniel B. Prieto
Jones Day

I. Introduction

This article provides an overview of the standards that govern the retention and payment of professionals in a bankruptcy case, including a description of certain of the relevant provisions in title 11 of the United States Code (the "Bankruptcy Code") and the Federal Rules of Bankruptcy Procedure (the "Bankruptcy Rules"). We also discuss some key issues related to the ability of professionals who serve in management roles for a debtor in possession to seek indemnification from the debtor or to access the debtor's director and officer ("D&O") insurance policy.

II. Retention of Professionals in Bankruptcy

A professional's retention by a trustee or debtor in possession in a case filed under the Bankruptcy Code will in most cases need the approval of the bankruptcy court pursuant to the relevant provisions in the Bankruptcy Code, the Bankruptcy Rules and any applicable local rules in the jurisdiction in which the bankruptcy case is filed (the "Local Rules").

A. General Retention Under Section 327(a)

Pursuant to section 327(a) of the Bankruptcy Code, a debtor may employ, with the bankruptcy court's approval, professional persons "that do not hold or represent an interest adverse to the estate, and that are disinterested persons," to assist the debtor during the bankruptcy case. 11 U.S.C. § 327(a). Section 327(a) of the Bankruptcy Code applies to "attorneys, accountants, appraisers, auctioneers, or other professional persons" that are employed "to represent or assist the trustee in carrying out the trustee's duties under" the Bankruptcy Code. 11 U.S.C. § 327(a). Basically, section 327(a) applies to all professional persons that are anticipated to play a fundamental role in the administration of the debtor's estate. Bankruptcy and local counsel, accountants, investment bankers, financial advisors and restructuring consultants typically are retained under section 327(a). Persons who are merely involved in the mechanics of the debtor's business operations or otherwise have a tangential relationship to the estate generally need not be retained under section 327(a). *See, e.g.*, *In re Johns-Manville Corp.*, 60 B.R. 612, 620-21 (Bankr. S.D.N.Y. 1986); *In re First Merchants Acceptance Corp.*, 1997 Bankr. LEXIS 2245, at *8-9 (Bankr. D. Del. Dec. 15, 1997). Among the persons that have been held not to be professionals whose employment requires prior court approval under section 327(a) are processors of claims belonging to the estate, environmental consultants, property managers, lobbyists, unlicensed brokers and expert witnesses. *See* 3 Collier On Bankruptcy § 327.02[6][a] (Alan N. Resnick, et al. eds., 15th ed. rev. 2007).

Section 327 is rooted in a "congressional intention to hold professionals performing duties for the estate to strict fiduciary standards." *See, e.g.*, *In re Envirodyne Indus., Inc.*, 150 B.R. 1008, 1016 (Bankr. N.D. Ill. 1993). The section's main policy objective is to assure that a professional employed in the case will devote undivided loyalty to the client. *See In re Lee*, 94 B.R. 172, 178 (Bankr. C.D. Cal. 1988). "Conflicting loyalties produce inadequate representation, . . . which threatens the interests of both the debtor and the creditors, and compromises the ability of the court to mete out justice

Overview of Issues *continued on p.* ***18***

Letter from the President

Grant T. Stein
Alston & Bird LLP

The evolution of the economic situation from the November, 2008 AIRA Journal to this one has continued to be unprecedented. A tremendous amount of time has been spent in the News and at the AIRA focusing on the bailout issues being considered for the U.S. Auto Industry. By the time this is printed the developments in that area will be known and I could speculate now, but it would be imprudent to do so (i.e. I don't want to be wrong). One of the other significant developments has been for Bernard L. Madoff Investment Securities, Inc. Its website reports what we all already know – the appointment of a Receiver and a SIPA Trustee and the SIPA proceeding before the United States Bankruptcy Court in the Southern New York.

A major area covered by our educational programs at the AIRA is fraud investigation, forensic accounting, and litigation support. It is part of our *bread and butter* so to speak. Think about all of our members who have involvement in Ponzi Scheme cases as a Receiver, Trustee, Examiner, financial advisor or counsel, and the litigation arising out of those matters. Several years ago in Dallas, the AIRA's Toolbox Session that preceded its Annual Seminar devoted an entire day to Forensic Accounting and Fraud. SEC Receiverships, state receiverships, bankruptcy cases, and the fraudulent conveyance and other litigation issues and defenses that they present is just one of the key areas in which we all have worked over the years.

The size of the cases – thousands, millions, or hundreds of millions - does not change the basics that we address in these situations – all that changes is the level of injury and the nature of the remedy we bring. Our resources are our knowledge and experience, and the challenging part is that we have to develop our solutions on real problems that affect real people.

Your resources likely include the educational programs the AIRA offers year in and year out. We cover what we do and enhance your knowledge base and skill sets through our educational programs, and consider that an essential part of our mission at the AIRA. The proliferation of Ponzi Scheme cases all over the country is something that will be addressed during the educational programs at the Annual Seminar in Orlando June 10-13, 2009. My firm belief, and the reason I have had the commitment to the AIRA I do, is because we lead in the educational arena. We can only continue to do that by your ongoing commitment to us and our programs.

I am writing this as we turn the corner into the Holiday Season. I hope each of you have had a good one and had some small break before embarking on 2009. I say that because it is going to be a very busy year, or two, or three, for us all.

Grant T. Stein

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

Mr. Stein is a Fellow of the American College of Bankruptcy and is identified as a top practitioner in Chambers USA: America's Leading Lawyers for Business, The Best Lawyers in America and Super Lawyers magazine. He serves as a director and president-elect of the Association of Insolvency and Restructuring Advisors (AIRA). He also is a director and president-elect for the Southeastern Bankruptcy Law Institute. He recently served as a Member of the executive committee of Emory University's Board of Visitors. He has written numerous articles on bankruptcy and workout issues and regularly lectures around the country. Mr. Stein served as law clerk to The Honorable W. Homer Drake, the senior judge of the United States Bankruptcy Court for the Northern District of Georgia, following his graduation, with honors, from the University of Georgia School of Law in 1981. He received his B.B.A., with high honors, from Emory University in 1978.

In This Issue

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AIRA extends special thanks to these **AIRA Journal** contributors:

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Executive Director's Column

Grant W. Newton, CIRA
AIRA

After two Board conference calls and a dozen drafts the Board approved the following letter dealing with congressional support for the U.S. automobile industry that was sent to Congress on Monday, December 8th. I am grateful to a large number of the members of the Board that helped draft and review various versions of the letter.

I wish you and your family the best in 2009.

Grant

LETTER TO CONGRESS

The Association of Insolvency and Restructuring Advisors is a nationwide not-for-profit organization serving the needs of business turnaround, restructuring and bankruptcy practitioners. With over 1,800 members, we are one of the leading bankruptcy and reorganization associations for accounting and financial advisors and offer members the most comprehensive bankruptcy certification program in the country. Our board of directors remains steadfastly committed to providing our members with relevant education programs and to taking a leadership role on legislative issues affecting the insolvency practice field. As practitioners and specialists in the field of distressed business, we appreciate the opportunity to provide our perspective on the crisis facing the U.S. automobile industry.

As Congress grapples with the immense and historic difficulties faced by the U.S. automobile industry, we urge our lawmakers not to exclude a time-tested and exemplary process for restructuring troubled companies – Chapter 11 of the U.S. Bankruptcy Code (the "Code").

A Chapter 11 filing would provide the following benefits:

The Code already has a well-known structure and process in place intended for situations precisely like this. A bailout or loan scenario would require reinventing a framework for restructuring through rules specially designed for the auto industry, requiring (literally) reinventing the wheel.

A Chapter 11 filing puts the restructuring process under the scrutiny of unbiased and highly qualified judges of the United States Bankruptcy Court (the "Court") and the Office of the U.S. Trustee, a division of the U.S. Department of Justice.

Chapter 11 provides an appropriately high level of transparency by requiring regular financial reporting, open Court hearings and a restructuring plan that is vetted in an adversarial context, with all relevant constituents having the opportunity to negotiate the final outcome and the results posted to the Court's publicly available web sites.

Should Congress decide that making funds available to the automobile manufacturers (whether as a credit guarantor or through direct lending) is in the best interest of the nation and its taxpayers, doing so within the context of a Chapter 11 filing protects this interest within an existing set of laws and would not require new legislation to deal with any possible inability to repay. If Congress authorizes direct funds to support the filing(s), the public funds advanced will have a position ahead of many pre-bankruptcy creditors.

We understand there is much opposition and fear regarding the stigma of a Chapter 11 filing by one or more of our largest and most important manufacturers. One concern most often expressed is that consumers may be reluctant to purchase a car from a manufacturer in Chapter 11. However, this fear can be mitigated. Courts routinely sign orders providing continuation and even enforcement of warranty claims. Many companies in Chapter 11 have successfully touted these types of orders in their advertising after their Chapter 11 filing.

We further recognize the immense complexity of the issues facing the U.S. automobile manufacturers and that no restructuring can be effective without significant pre-bankruptcy planning. In cases of this size, a coordinated effort between debtors and their key stakeholders (including vendors, unions, etc), accompanied by a well thought-out strategic public relations effort to allay fears and misunderstandings of consumers and vendors, would be essential for any successful reorganization. With this in mind, far from being a "death knell," Chapter 11 gives the filing company financial breathing room as it continues to operate and keep its employees on the payroll. Indeed, in some respects, employees have added protection since any unpaid payroll is treated as a priority claim, requiring payment as a precondition to paying other unsecured creditors. In addition, Court orders at the commencement of a Chapter 11 case often provide for continuation of wage and benefit programs. Labor contracts, consumer issues such as warranty claims and vendor issues have all been dealt with at length by the bankruptcy system.

As with any other possible solution to the current crisis, there are well documented risks and pitfalls related to a Chapter 11 filing. However, Congress has many examples of Chapter 11 as a viable tool for restructuring complex troubled businesses. The bankruptcy system has provided a framework for ensuring payment of hundreds of millions of dollars to victims of asbestos exposure, while maintaining the viability and integrity of many manufacturers and protecting thousands of jobs. The airline, telecommunications, steel and construction industries, and nearly every other industry in the United States, have all had their share of companies both large and small going through the Chapter 11 process and emerging stronger, healthier and more focused.

We recognize that the restructuring of the U.S. automobile manufacturers will be a financially painful process. Chapter 11 would help assure that no single issue or party bears a disproportionate share of that pain by allowing the parties to address in an equitable manner the financial crisis and strain that will certainly result. Chapter 11 has proved to be an adaptive and flexible system that brings with it financial integrity, transparency and judicial oversight. Without the structure and order imposed by the U.S. Bankruptcy Code and without a Bankruptcy Judge to be the final decision maker when compromise or consensus cannot be achieved, the auto manufacturers, like other companies before them, may be forced into a restructuring process much more complex and costly than the Chapter 11 alternative and one less likely to be successful.

In closing, we once again urge Congress not to reject the many benefits of its own remedy for dealing with companies in severe financial distress, the U.S. Bankruptcy Code, as an efficient, fair and transparent method for protecting the interests of the affected companies, all of their constituents and the taxpayers.

Respectfully,

Signed by Grant W. Newton

AIRA Scholar in Residence

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

BANKRUPTCY RETAKES
Of Disallowance, Disgorgement, and Malpractice: The Saga of SonicBlue

Bankruptcy Code section 327(a) requires full disclosure of any lack of disinterestedness or any potential conflicts or adverse claims against the bankruptcy estate. Bankruptcy Code section 328(c) implicitly makes this disclosure requirement a continuing duty to inform a continuing obligation on the part of professionals retained or paid by the estate. Bankruptcy Rule 2014(a) requires full disclosure of all "connections" a professional person may have with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed by the in the office of the United States trustee. This disclosure is in the form of a verified statement of the person to be employed. Bankr. R. 20014(b). As presently interpreted, Bankruptcy Rule 2014 also imposes a continuing duty to disclose once new facts are discovered or errors or omissions in disclosures are identified, a reading I believe does not square with the language of Bankruptcy Rule 2014. That point, however, must be left for another day.

In the past, violations of section 327 and Rule 2014 could result in denial of retention of professionals, disallowance of fees, and, in extreme cases, disgorgement of fees paid. Because of the SonicBlue, Inc. bankruptcy case, one may add potential legal malpractice actions and, for a time being, a potential criminal referral to the mix of sanctions available for alleged violations of section 327 and Rule 2014.

The saga of SonicBlue, the creator of the Rio MP3 player, paints a disturbing picture. This bankruptcy case was filed in the Bankruptcy Court of the Northern District of California. The Bankruptcy Judge is Judge Marilyn Morgan. On March 26, 2007, the bankruptcy court entered an order disqualifying SonicBlue, Diamond Multimedia Systems, Inc., Replay TV, Inc., and Sensory Science Corporation's (collectively, the "Debtors") counsel, Pillsbury Winthrop Shaw Pittman LLP ("Pillsbury"), for violating both the Bankruptcy Code and Bankruptcy Rules by failing to disclose certain conflicts and connections with the Debtors. The bankruptcy court also ordered the appointment of a chapter 11 trustee. On April 17, 2007, the bankruptcy court approved a motion by the U.S. Trustee to appoint Dennis J. Connolly as the chapter 11 Trustee (the "Trustee").

After almost a year of investigations, the Trustee brought a complaint (the "Complaint") against Pillsbury. According to the Complaint, Pillsbury served as counsel to the Debtors from 1989 through March 26, 2007, when the bankruptcy court entered its order disqualifying Pillsbury. In the Complaint, the Trustee alleged that:

> Pillsbury's continuing and systematic failure to (i) fulfill its ethical obligations to the Debtors; (ii) exercise an ordinary degree of professional skill in representing the Debtors; and (iii) satisfy the disclosure obligations imposed by the Bankruptcy Code and the Bankruptcy Rules, damaged the Debtors' estates, creditors, the judicial system, and the bankruptcy process.

The specific allegations contained in the Complaint center around four general themes:

> First, as a result of Pillsbury's failure to fulfill its ethical obligations to the Debtors, at no time was Pillsbury "disinterested" as defined in Section 101(14) of the Bankruptcy Code. Accordingly, Pillsbury was not properly retained under Section 327(a) of the Bankruptcy Code. Second, Pillsbury's failure to fulfill its professional obligation to exercise an ordinary degree of professional skill while representing the Debtors has resulted in significant delay and harm to creditors in these cases. Third, in furtherance of and in addition to its ethical lapses, Pillsbury failed to comply with Bankruptcy Rule 2014 and its requirement that retained professionals provide full and complete disclosure of their connections to the Debtors and their bankruptcy cases. Pillsbury's lack of candor with the Court, the U.S. Trustee, and creditors in these cases has caused significant delay in these cases and resulted in an exponential increase in the cost of administering the estates. Furthermore, Pillsbury's affirmative acts – taken in furtherance of its desire to remain the Debtors' bankruptcy counsel – were in willful and conscious disregard of the truth.

In the Complaint, the Trustee alleged disclosure failures that included:

- Pillsbury's receipt of legal fees which subjected it to significant preference exposure;
- Pillsbury's having rendered legal advice in connection with the negotiation and issuance of SonicBlue's 2002 Indenture which resulted in certain creditors, including certain SonicBlue officers and directors, threatening to bring claims against Pillsbury SonicBlue;
- Pillsbury's having entered into a tolling agreement to hold in abeyance certain of the aforementioned claims; and
- The 2002 Noteholders' demand made against Pillsbury for indemnification due to claims to provide notice of certain demands and threatened claims made by Debtors'

creditors to the insurers with whom SonicBlue's directors and officers insurance policies were held.

The Trustee further alleged that Pillsbury failed to provide adequate advice (and in some cases any advice whatsoever), to the Debtors concerning the following:

- The possibility that issuing the 2002 Notes might raise a claim that SonicBlue was engaged in "death spiral" financing;
- The fiduciary duties SonicBlue owed to its creditors before SonicBlue elected to proceed with the issuance of the 2002 Notes, its sale of certain stock and while within the "zone of insolvency";
- That certain claims and demands needed to be disclosed to the insurance carriers holding the above-described directors and officers insurance policies;
- That the 2002 Noteholders (defined below) demanded that the Debtors' settlement with VIA (defined below) include a provision that resolved a potential priority dispute between those two creditors and that the Debtors could potentially obtain consideration from the 2002 Noteholders for resolving this potential priority dispute;
- That the Debtors needed to file certain tax returns for 2002 and 2003;
- The need for SonicBlue to file continuation statements in order to maintain recorded security interests in certain property;
- The need for the Debtors to file proofs of claims so that they could seek compensation or reimbursement for intercompany claims; and
- The need for SonicBlue to take certain steps to preserve its directors and officers insurance policies.

In the Complaint, the Trustee demanded judgment against Pillsbury in the form of a litany of remedies including:

- disallowance and disgorgement of all fees paid to Pillsbury over the course of these cases, plus interest on those fees calculated at the applicable rate of interest from the date of payment;
- disallowance of all contingency fees generated by Pillsbury over the course of these cases;
- an award of compensatory damages for damages caused by Pillsbury's malpractice and breach of the fiduciary duties owed to the Debtors, including all costs associated with the Trustee's investigation including his reasonable attorneys' fees; and
- the imposition of punitive damages against Pillsbury arising out of Pillsbury's malicious conduct which was carried out with a willful and conscious disregard of the rights of the Debtors, the Debtors' estates and the Debtors' creditors.

Unfortunately, things have gone from bad to worse. Subsequent to the filing of the Complaint, an attorney for one of the key creditors in the bankruptcy case sought a criminal referral of a Pillsbury partner for his failure to correct a false declaration. Specifically, the request to refer the matter for potential criminal prosecution by the U.S. Attorney's office centers on the Pillsbury partner's failure to disclose payments the firm received that allegedly affected its status as a disinterested party. Moreover, on July 23, 2008, Bankruptcy Judge Marilyn Morgan issued an opinion largely denying a motion to dismiss the Complaint filed by Pillsbury. More recently, in early October 2008, the bankruptcy court denied a motion for partial summary judgment filed by the Chapter 11 trustee, finding that some factual issues were left regarding the actual degree of disgorgement to order against Pillsbury for violating the Bankruptcy Code and Rules. In late November 2008, the confirmed plan became effective and the trustee intends to distribute some $74 million to the creditors. All litigation has been settled save the action against Pillsbury. Trial is expected some time in 2009.

The teachings from a case like SonicBlue are illuminating. First, the ongoing duty to disclose includes a continuing duty to correct errors and omissions in a timely and prompt manner. Second, failure to adequately disclose or to correct material errors and omissions may lead to disqualification, denial of fees, and, in some instances, disgorgement. Third, the sanctions listed in the previous sentence, although appropriate in certain instances, do not exhaust the litany of sanctions available to a court under its supervisory or inherent powers to sanction misconduct. Fourth, in the appropriate circumstances, the same allegations that would support a motion to disqualify, disallow, or disgorge fees, may also support a claim based on legal malpractice. Ironically, then, section 327 and Rule 2014 may, in the appropriate circumstances, gin up assets for the estate. Finally, in the appropriate circumstances, a knowing failure to correct a misleading or incomplete disclosure may result in a criminal referral and subsequent prosecution for perjury or false swearing. Thus, the potential universe of damages may exceed the actual fees paid to a law firm.

SonicBlue is developing into a tragedy of sorts. The allegations in the Complaint paint Pillsbury in a bad light, neglecting its duties as imposed by the Bankruptcy Code and the Bankruptcy Rules. It is important to note that the Trustee has not proved its claims for relief; the case is still in the pretrial discovery stage. However, Pillsbury has been unceremoniously disqualified from representing the Debtors. For Pillsbury, it may only get worse from here. ■

Taxation Cases

Forrest Lewis
Plante & Moran PLLC

DATE OF DISCHARGE: KEY TAX EVENT

Whenever debt is discharged in bankruptcy or otherwise, the date of discharge is critical. Under Internal Revenue Code Section 61, a discharge or cancellation of debt is taxable unless excluded under one of the provisions of IRC Section 108. If the income is excluded from tax under Section 108, there is a certain price to pay as under IRC Section 1017(a), certain favorable tax attributes, primarily net operating loss carryforwards and asset bases, must be reduced on the first day of the next taxable year. Therefore, knowing the date of debt discharge is necessary to knowing in which tax year the income is taxable or if excluded in which year the favorable attributes will be reduced. Since the date of discharge is a fine point of law, it is an issue that we accountants and consultants must rely on the attorneys to determine. Not being an attorney, I will do my best to relate the rules about date of discharge as I understand them, to the income tax consequences of the discharge. In some cases, identifying the date of discharge will be quite simple; in others, it will be difficult. The scope of this article is limited to determining the date of corporation and partnership discharges, those of individual taxpayers are not covered.

Chapter 11 cases

In Chapter 11 cases, Bankruptcy Code Section 1141(d) generally provides that debts are discharged upon the confirmation date (or Effective Date, if there is one) of the Plan of Reorganization. In liquidation cases, the remaining assets are usually either distributed to creditors or transferred to a liquidating trust for benefit of the creditors. All unsatisfied debts are generally discharged on that confirmation date. In that simple case, the reduction of favorable tax attributes will occur on the first day of a debtor corporation's next tax year. (In partnerships, the attribute reduction takes place at the partner level). In reorganization cases often stock equity is issued to creditors but if there are debts which are discharged, the confirmation date will again trigger the attribute discharge on the first day of the next tax year. The following simplified examples which ignore alternative minimum tax will illustrate:

> Example 1: Deficit Corporation has a net operating loss carryforward of $50 million as of December 31, 2003 and files its tax returns on the calendar year. Deficit Corporation files a petition for relief in Chapter 11 on February 5, 2004. Under IRC Section 1399, the corporation remains on the calendar year and incurs a net operating loss of $1 million for 2004. On June 22, 2005, a Plan of Reorganization providing for sale of the assets and a liquidation is confirmed. All of the assets are sold in July, 2005 but since they were fully secured, all proceeds go the secured creditors. Nothing is available for the unsecured creditors whose claims total $33 million and so they are discharged on the confirmation date. The taxable income for 2005, primarily the gain on sale of the assets, is $20 million but it is fully offset by the net operating loss carryforward. On January 1, 2006, the net operating loss carryforward is completely eliminated (50+1-20-33). Since the assets have all been sold, no substantial future income is expected, so the reduction of the net operating loss carryforwards does no harm.

Sometimes the case does not follow the common pattern discussed above. Sometimes the Trustee makes a global settlement with creditors without benefit of a confirmed plan and confirmation date, as in the celebrated Picadilly Florida document tax case. In that instance, presumably there is an equivalent of the confirmation date, so that the timing of attribute reduction in the next year is known. Another anomalous fact pattern involves the Trustee making a series of settlements at a discount with individual creditors over a period of time straddling the year-end of the debtor corporation. This creates a much more difficult situation in that the amount of debt discharge for the year must be computed piecemeal, and then offset against the tax attributes of the debtor on the first day of the next tax year. That means the debtor corporation starts the new year in which it may recognize taxable income from sale or transfer of assets, successful lawsuits and preference actions, but with a reduced level of net operating losses, asset basis, etc., to offset the tax.

> Example 2: the facts are the same as in Example 1 except that the taxable income for 2005 is $19 million, mainly from the sale of most of the assets. However, assets yielding a gain of $1 million could not be sold until 2006. Under these facts, the net operating loss carryover is still completely eliminated on January 1, 2006 (50+1-19-33). Now there is no net operating loss to offset the tax on the $1 million 2006 gain.

Chapter 7 cases

Apparently, nothing in the Bankruptcy Code authorizes a discharge to nonindividual, i.e. corporate or partnership, debtors in Chapter 7 liquidation cases. This is noted in Collier on Bankruptcy, chapter 15, par. 6.02. The point was illustrated in the case of Friedman v. Commissioner, 75 T.C.M. (CCH) 2383 (1998) , aff'd, 216 F.3d 537 (6th Cir. 2000). (This is one of those cases where the IRS argued a point to win one case which appears to set a precedent contrary to its own interest.) Years ago a number of S corporation shareholders realized a double tax benefit by claiming that the nontaxable income from Section 108 debt discharge increased the basis in their S corporation stock for which they then took a worthless stock deduction. In the Friedman case the IRS fended that off by stressing that there had been no discharge to trigger nontaxable income to the shareholders because it was a Chapter 7 case and there is no provision for discharge in a Chapter 7 corporation case. Later, to the astonishment of many observers, the double tax benefit strategy was upheld by the U. S. Supreme Court in Gitlitz which prompted the Congress to immediately change the Internal Revenue Code to eliminate the increase in stock basis in those circumstances. It seems doubtful now that IRS will permit a taxpayer to take the position they have no attribute reduction in a business Chapter 7 case because there is no technical discharge. Presumably, the date of discharge in a Chapter 7 case will have to be determined from the facts and circumstances, as discussed below in nonbankruptcy situations.

Discharges of debt outside of bankruptcy

Outside a title 11 case, the time when a debt is discharged or cancelled can be difficult to determine. As a general rule, a debt is discharged when one of the following identifiable events occurs: (1) the debt is forgiven by an express agreement of the parties (2) the debt is cancelled by a conclusive unilateral act of the creditor (3) the debt is cancelled by operation of law (4) a creditor accepts payment of an amount less than face amount of the debt in complete satisfaction (5) the moment it becomes clear the debt will not be repaid, based on the facts and circumstances relating to the likelihood of repayment. Some courts have held that a discharge occurs when the evidence (an ''identifiable event") indicates that the debt will not be repaid.

Conclusion

Knowing when a debt is discharged or cancelled is important to knowing the timing of taxable income or excluded income under Section 108. Income excluded under Section 108 starts the clock running for the reduction of favorable tax attributes in the following tax year. If the timing is not right, valuable tax attributes can be lost which could be used to reduce taxes incurred from sale of assets, recovery of preferences, amounts realized through lawsuits, etc.

EARLY IRS RESPONSES TO CREDIT CRISIS

The Internal Revenue Service has responded to the ongoing credit crisis with a number of pronouncements to relieve the tax position of adversely affected taxpayers. Only one ruling so far has been specific to bankruptcy situations and several deal with the IRC Section 382 limits on loss carryovers. So far, the relief provided has fairly narrow application.

1. Liberalization of borrowed securities rule when default is due to bankruptcy of the borrower (Revenue Procedure 2008-63).

Under Internal Revenue Code Section 1058, a taxpayer is permitted to exchange securities without tax via loan and return of identical securities which meet certain conditions. Brokers frequently borrow securities to complete sales of securities because of delays that they face in obtaining securities from sellers and transfer agent without creating a taxable transaction. Encouraging brokers to borrow securities in these transactions is considered desirable from a market standpoint. Recently, a significant number of securities loans have terminated as a result of default by the borrower of the securities. These defaults are often the direct or indirect result of the bankruptcy of the borrower (or an affiliate of the borrower). For example, the bankruptcy of the borrower might, by itself, constitute an event of default under the securities loan agreement. Likewise, the bankruptcy of an affiliate of the borrower might indirectly prevent the borrower from returning identical securities upon notice of termination by the lender, if, for example, such a bankruptcy affects the borrower's liquidity and practical ability to acquire identical securities in the secondary market. In many of these situations, the lender sells collateral provided by the borrower and thereafter purchases identical securities (and the borrower's obligation to return identical securities is terminated). The selling of the collateral generally constitutes a taxable transaction.

To reduce hindrance to securities lending in the current environment, in cases of default resulting from the bankruptcy of a borrower (or borrower's affiliate), the IRS will permit the lender to sell the collateral without incurring a taxable gain if the proceeds are used to purchase securities identical to the original ones lent. The lender must sell the collateral and acquire the replacement securities as soon as commercially practicable (and not longer than 30 days after the default). Effective for taxable years ending on or after January 1, 2008.

2.Liberalization of limitations on net operating loss carryovers when corporate ownership changes (IRS Notice 2008-78).

When a loss company is sold or reorganized and more than 50% of the ownership interests change hands, IRC Section 382 triggers limitations on the use of favorable tax attribute carryovers such as net operating losses, credits and so called "built in losses." Generally that section requires an amortization of such tax attributes based on the fair market value of the corporation multiplied by the IRS interest rate known as the applicable federal rate. [Example: Loss Corporation's stock is acquired by Profit Group in exchange for $10,000,000 of Profit Group stock in a nontaxable reorganization under Sec. 368. Loss Corporation has a $12,000,000 net operating loss carryforward. The IRS interest rate is 6%. The annual amount of Loss Corporation's net operating loss which can be deducted in the future is $600,000.]

Generally, Sec. 382(l) provides that any capital contributions made to a loss corporation two years before the date of ownership change are presumed to be intended solely to artificially increase the value of the corporation and so are disregarded in establishing the fair market value of the corporation. The IRS notice says that IRS intends to promulgate regulations which will <u>not</u> presume an intent to artificially increase the fair market value of the loss corporation under certain circumstances:

(a) The contribution is made by a person who is neither a controlling shareholder (determined immediately before the contribution) nor a related party, no more than 20% of the total value of the loss corporation's outstanding stock is issued in connection with the contribution, there was no agreement, understanding, arrangement, or substantial negotiations at the time of the contribution regarding a transaction that would result in an ownership change, and the ownership change occurs more than six months after the contribution. (The contribution can be made by a related party but no more than 10% additional stock can be issued and this must occur one year before the ownership change date).

(b) The contribution is made in exchange for stock issued in connection with the performance of services, or stock acquired by a retirement plan, under certain terms

(c) The contribution is received on the formation of a loss corporation (not accompanied by the incorporation of assets with a net unrealized built in loss) or it is received before the first year from which there is a carryforward of a net operating loss, capital loss, excess credit, or excess foreign taxes (or in which a net unrealized built-in loss arose).

Taxpayers may act in reliance on this notice which is effective for taxable years ending on or after September 26, 2008.

Commentary: Sometimes the old shareholders make capital contributions to allow the entity to continue in business until it can be transferred, but apparently under this rule, only a minority shareholder can do so and receive the benefit of the notice. There appears to be no requirement either that the contributing shareholder terminate ownership or remain as a shareholder. Note that the 382 annual limitations will continue to apply, the fair market value of the corporation may just be higher because of the six month or year old capital contribution. Not a lot of relief there. Also, note that there are more liberal rules already found in 382(l)(5) and (6) for companies in bankruptcy, see the article in this column on the Eddie Bauer and Conseco cases in the October-November, 2006 issue.

3. Liberalized position on certain built in losses of banks under Sec. 382 (Notice 2008-83).

Just as Sec.382 limits the use of net operating loss carryovers when there is a change of ownership, it also limits the use of so called "built in losses" in the same way, the "amortization" method over a period of years using the IRS interest rate. Built in losses arise from latent losses which have not yet been recognized under the company's tax accounting method. An issue that is always present when a bank changes hands is whether loan losses recognized after the change date had existed before the change date, in which case they will be limited under Sec. 382.

This pronouncement provides that "any deduction properly allowed after an ownership change to a bank with respect to losses on loans or bad debts (including any deduction for a reasonable addition to a reserve for bad debts) shall not be treated as a built-in loss or a deduction that is attributable to periods before the change date." Therefore the deduction for the loss incurred will not be limited by Sec. 382 and will be immediately deductible.

The notice does not provide an effective date, but it was issued on September 30, 2008 and says that a bank may rely on the notice until further guidance is provided.

4. Other relief pronouncements

- Preserving net operating losses of Freddie Mac, Fannie Mae, banks and other financial firms in which the federal government takes an equity position- Notice 2008-84
- Holding that money market funds which participate in the federal Guarantee Program to maintain price per share at the $1 level will not suffer certain adverse tax consequences-Notices 2008-81 and 2008-92
- Other pronouncements deal with auction rate securities, municipal bonds, loans by foreign corporations, etc. which are beyond the scope of this article. ■

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Bankruptcy Cases

Baxter Dunaway

Bankruptcy
Sixth Circuit
Is a refinanced mortgage protected from preference liability by the earmarking doctrine, the no-diminution-of-the-estate argument or equitable subrogation?

A late-perfecting secured creditor in the context of a refinanced mortgage is not protected from preference liability by the earmarking doctrine, the no-diminution-of-the-estate argument or by equitable subrogation. *Chase Manhattan Mortgage Corp v. Shapiro (In re Lee),* 530 F.3d 458 (6th Cir.2008).

In *Lee,* the debtor purchased a residence in Michigan, with the purchase financed by a mortgage loan and secured by a recorded mortgage on the realty. Chase Mortgage Company ("Chase") eventually became the holder of the loan note and the mortgage. Approximately six months before the debtor's bankruptcy filing, the debtor refinanced his residential mortgage loan (New Mortgage) also with Chase. On October 6, 2003, Chase disbursed the new loan proceeds to pay off the earlier loan held by it, but the new mortgage granted Chase was not recorded until December 17, 2003, 72 days later. The debtor filed for bankruptcy relief under chapter 7 on March 4, 2004, 77 days after the recording of Chase's new mortgage. The chapter 7 trustee sought to avoid the new mortgage granted Chase as a preferential transfer under § 547(b). The bankruptcy court granted summary judgment for the trustee, finding that the trustee had met his burden on all elements under § 547(b) and that the earmarking doctrine did not apply. *Chase Manhattan Mortgage Corp v. Shapiro (In re Lee),* 326 B.R. 704, 708 (Bankr.E.D.Mich.2005), *rev'd* 339 B.R. 165 (E.D.Mich.2006). Although the district court reversed, the court of appeals reinstated the bankruptcy court's judgment in favor of the trustee. *In re Lee,* 530 F.3d 458.

The Earmarking Doctrine
The bankruptcy court avoided the New Mortgage as a preferential transfer because it found that the Trustee had met its burden on all elements under § 547(b) and found that the earmarking doctrine did not apply. The bankruptcy court reasoned that because the New Mortgage was not recorded and perfected for more than two months after the initial transaction, the perfection did not relate back to the initial transfer pursuant to § 547(e)(2)(B). The earmarking doctrine is a judicially-created defense that may be invoked by a defendant to a preference action in an attempt to negate § 547(b)'s threshold requirement-a transfer of an interest of the debtor in property. In order for the doctrine to apply, however, it must be that: (a) the agreement is between a new creditor and the debtor for the payment of a specific antecedent debt; (b) the agreement is performed according to its terms; and (c) the transaction according to the agreement does not result in a diminution of the debtor's estate. 530 F.3d 458, 468. The court rejected Chase's earmarking argument, finding that there were two transfers in this case: the October 6 transfer of funds from Chase to the debtor to release the Original Mortgage and the transfer perfecting the security interest through the recording of the New Mortgage on December 17. The court held that the earmarking doctrine protected only the first transfer.

When applying the earmarking doctrine in the context of a refinancing transaction, courts have split over whether to characterize the refinancing as a single unitary transaction or as a number of parts. See cases cited at 530 F.3d 468 and David Gray Carlson & William H. Widen, *The Earmarking Defense to Voidable Preference Liability: A Reconceptualization,* 73 Am. Bankr.L.J. 591, 602 n. 63 (Summer 1999) ("[*In re Heitkamp*] wrongly invoked earmarking in a context in which the concept does not fit.").

Diminution of the Debtor-Estate's Assets: § 547(b)(5)
The court next rejected Chase's argument that there was no diminution of the Debtor-estate's assets as required by § 547(b)(5), finding that because Chase delayed in perfecting its mortgage lien, the Court could not treat the October 6 refinancing as part of the same transaction as the transfer of the lien recorded on December 17. 530 F.3d 472. Because the two transactions were separate transactions, the diminution requirement was met because perfection of the New Mortgage elevated Chase from unsecured to secured status, resulting in fewer assets of the Debtor's estate for other unsecured creditors. The court granted the Trustee's motion for summary judgment, holding that the estate was diminished by the December 17 perfection of the New Mortgage, and that the secured interest was an avoidable preference.

Chase's Policy Argument and Equitable Subrogation
Chase argued that imposing preference liability on it would be unfair and against public policy because the refinancing transaction involved a mere substitution of its New Mortgage for the Original Mortgage and ultimately benefitted the Debtor's other creditors, not Chase. In rejecting this, the Court's response was: "Congress, by enacting § 547(e)(2), has determined the appropriate length of time between a creditor's transfer of value and perfection: originally 10 days, now expanded to 30 days by BAPCPA. By hewing to the plain meaning of the Code and respecting Congress's judgment in enacting § 547(e)(2), our holding today fosters predictability in the law of preferences." 530 F.3d 473. On the policy arguments, compare the dissent of Judge Merritt in *Lee.* 530 F.3d 474.

The Court also rejected Chase's reliance on the doctrine of equitable subrogation. For the application of equitable subrogation in a refinancing preference case, see, the Eleventh Circuit *Hedrick* case that held that equitable subrogation can be used to relate back to prior mortgage to preclude preferential treatment of late recorded refinancing mortgage. In re Hedrick, 524 F.3d 1175 (11th Cir.(Ga.), Apr 15, 2008). *Hedrick* was not cited in the *Lee* case. The Court in

Lee summarily rejected the application of the doctrine: "In declining to apply the equitable subrogation doctrine to shield the late-perfecting mortgagee from preference liability, we noted that the mortgagee was a sophisticated creditor facing a problem of its own making." 530 F.3d 473-474.

Research references: Dunaway, The Law of Distressed Real Estate, § 34:54. 90-day transfers that are avoidable as preference—Transfers of interest of debtor (Westlaw LAWDRE).

Fifth Circuit

Does a reorganized debtor have standing to pursue claims based on the defendants' preconfirmation management of the estate's assets if the claims have not been retained in the confirmed plan?

Here, the question is whether Dynasty, a reorganized debtor, has standing to pursue claims based on the Appellees' pre-confirmation management of the estate's assets. The Court of Appeals concluded it does not because the claims were not retained in the confirmed plan. In re United Operating, LLC, 540 F.3d 351, 50 Bankr.Ct.Dec. 100, (5th Cir. 2008).

Reorganized debtor Dynasty, which survived as a shell corporation after all of its assets were liquidated in a Chapter 11 bankruptcy, brought post-confirmation action against creditor, creditor's loan officer, company that had been appointed by the court to operate debtor's oil and gas properties, and company's principal, asserting, *inter alia*, that its properties had been mismanaged during the reorganization.

During its Chapter 11 case, Dynasty as a debtor-in-possession, had most of the powers of a bankruptcy trustee to pursue claims on behalf of the estate. 11 U.S.C. § 1107(a). Upon confirmation of the plan, the estate ceased to exist, and Dynasty lost its status as a debtor "in possession." 11 U.S.C. § 1101(1). At that time, Dynasty's authority to pursue claims as though it were a trustee also expired. *In re Ice Cream Liquidation, Inc.*, 319 B.R. 324, 333 (Bankr.D.Conn.2005) (debtor-in-possession status, along with the relevant powers of a trustee, "ceases on the effective date of a confirmed plan"). 540 F.3d 351 at 355.

Nonetheless, in some cases the Code allows a reorganized debtor to bring a post-confirmation action on a "claim or interest belonging to the debtor or to the estate." 11 U.S.C. § 1123(b)(3). A debtor may preserve its standing to bring such a claim (*e.g.,* for fraud or breach of fiduciary duty, or to avoid a preferential transfer but only if the plan of reorganization expressly provides for the claim's "retention and enforcement by the debtor." § 1123(b)(3)(B). After confirmation of a plan, the ability of the debtor to enforce a claim once held by the estate is limited to that which has been retained in the plan. 540 F.3d 351 at 355.

For a debtor to preserve a claim, the plan must expressly retain the right to pursue such actions. The reservation must be "specific and unequivocal." If a debtor has not made an effective reservation, the debtor has no standing to pursue a claim that the estate owned before it was dissolved. This is a logical consequence of the nature of a bankruptcy, which is designed primarily to secure prompt, effective administration and settlement of all debtor's assets and liabilities within a limited time. 540 F.3d 351 at 355.

Research references: Dunaway, The Law of Distressed Real Estate, § 29:63. Effect of confirmation—In general and discharge.

Ninth Circuit

Is an oversecured creditor whose claim was paid in full through a § 363 asset sale entitled to interest at the contractual default rate under § 506(b)?

Oversecured creditor whose claim was paid in full through a § 363 asset sale is entitled to interest at the contractual default rate under § 506(b) unless the rate is unenforceable under nonbankruptcy law. *General Elec. Capital Corp. v. Future Media Prods, Inc.* 530 F.3d 1178 (9th Cir.), *opinion amended*, 536 F.3d 969, 2008 WL 3091471 (9th Cir. Aug 7, 2008). Reversed and remanded.

The Court of Appeals held that there was nothing in the Bankruptcy Code to prevent oversecured creditor from collecting interest at default rate, pursuant to its prepetition contract with Chapter 11 debtor-borrower, in case in which debtor was not curing its prepetition default by payments under plan, but paying creditor's claim out of proceeds from sale of assets securing it; abrogating *In re 433 South Beverly Drive,* 117 B.R. 563 (Bankr.C.D.Cal.1990) and *In re Casa Blanca Project Lenders, L.P.,* 196 B.R. 140 (9th Cir.BAP 1996).

The Court's analysis starts from a general premise articulated by the Supreme Court: "[c]reditors' entitlements in bankruptcy arise in the first instance from the underlying substantive law creating the debtor's obligation, subject to any qualifying or contrary provisions of the Bankruptcy Code." *Travelers Cas. & Sur. Co. of Am. v. Pac. Gas & Elec. Co.,* —U.S. —, 127 S.Ct. 1199, 1204-05, 167 L.Ed.2d 178 (2007). The Court read *Travelers* to mean the default rate should be enforced, subject only to the substantive law governing the loan agreement, unless a provision of the Bankruptcy Code provides otherwise.

In *In re Entz-White Lumber and Supply, Inc.,* 850 F.2d 1338 (9th Cir.1988), the Court had announced the rule that an oversecured creditor was not entitled to interest at the default rate where its claim was paid in full *pursuant to the terms of a Chapter 11 plan*. Because the Code allows the debtor to "cure" defaults under a Chapter 11 plan, the Court permitted the debtor to nullify the interest owed at the default rate. In the current case there was never any question of whether the debtor needed to cure a default to render it unimpaired for voting on a Chapter 11 plan. Instead, the oversecured claim was paid through a sale of assets governed by § 363, *outside the context of a Chapter 11 plan*. As a result, the Court found the facts of *Entz-White* distinguishable, and thus the per se rule from that case inapplicable.

Research references: Dunaway, The Law of Distressed Real Estate, § 29:33. Assessing property's value—Significance of valuation.; Norton Bankr. L. & Prac. 3d § 52:9. Postpetition interest (Code § 506(b)).

Ninth Circuit

Is an order for the removal of a trustee a final order over which the courts of appeals have jurisdiction? What are the standards for removal of a trustee under § 324 for conflict of interest?

The Ninth Circuit followed the Eleventh Circuit (*In re Walker,* 515 F.3d

1204, 1210-11 (11th Cir.2008)) which had held that the removal of a trustee is a final order over which the courts of appeals have jurisdiction pursuant to 28 U.S.C. § 158(d) and 2) "Cause" for removal of a trustee under § 324 may include a conflict of interest. Section 701(a)(1) requires that a trustee be disinterested, and the definition of disinterested person under § 101(14) is broad enough to include a trustee with some interest or relationship that would even faintly color the required independence and impartial attitude. *Dye v. Brown* (In re AFI Holding, Inc)., 530 F.3d 832, 836, 2008 WL 2420706 (9th Cir. 2008).

The Court of Appeals considered what constitutes cause for removal under § 324 and adopted the standard in the opinion in *In re AFI Holding, Inc.* 355 B.R. 139 355 B.R. 139 (9th Cir. BAP 2006). The BAP held that (1) "cause" may include a lack of disinterestedness; (2) the catch-all provision of 11 U.S.C. § 101(14)(E) defining a "disinterested person" is "broad enough to exclude a trustee with some interest or relationship that 'would even faintly color the independence and impartial attitude required by the Code,' " *Id.* at 149 (quoting *In re Crivello,* 134 F.3d 831, 835 (7th Cir.1998)); (3) the First Circuit's "full panoply of events and elements" test or "totality of the circumstances" to determine whether a particular conflict is "materially adverse" to the estate sufficient to find a lack of disinterestedness is the appropriate standard, *id.* at 151; *see In re Martin,* 817 F.2d 175, 182 (1st Cir.1987); and (4) the bankruptcy court did not abuse its discretion in concluding removal was proper due to the Trustee's past affiliations with insiders that created a potential for a materially adverse effect on the estate and an appearance of impropriety resulting in ongoing disharmony in the estate's administration. The BAP also concluded that the bankruptcy court properly considered the trustee's failure to disclose these prior affiliations to the U.S. Trustee. 530 F.3d 832, 837-8.

Research References: Dunaway, The Law of Distressed Real Estate, § 28:9.10. Appeals; § 28:12. Trustee—In general.

Tenth Circuit

What constitutes a § 524(a)(2) violation of the discharge injunction?

In an adversary proceeding brought by former Chapter 7 debtors, the bankruptcy court ruled that debtor's former partner violated the discharge injunction when, in state court litigation against a corporate business she jointly owned with debtor, she sought discovery from the debtors regarding the assets and operation of the business and obtained sanctions when they did not comply, and supplemented her pleadings to allege claims for post-petition wrongdoing by debtor in connection with the wind-up of the business. The United States District Court affirmed, and former partner appealed.

In reversing, the Court of Appeals noted the principles that govern actions for violation of the discharge injunction. A bankruptcy court may sanction a party for violating the discharge injunction only if the party took some action prohibited by § 524(a)(2), i.e., an action "to collect, recover or offset any [discharged] debt... of the debtor." The Court of Appeals held that former partner's continuation of state litigation against debtor's business, even with the debtors nominally remaining in the case as defendants, did not violate discharge injunction and, thus, was not a basis for imposing sanctions against her nor was discharge injunction violated merely because she pursued discovery and sought sanctions for noncompliance against the debtors. *In re Paul,* 534 F.3d 1303, 2008 WL 2877476 (10th Cir. 2008).

Research References: Dunaway, The Law of Distressed Real Estate, § 28:108. Effect of discharge.

Tenth Circuit

Is more than mere closeness required to hold that a creditor is a non-statutory insider of a debtor?

Under 11 U.S.C. § 547(b) a bankruptcy trustee may avoid, or force a creditor to repay to the debtor's estate, a transfer of an interest of the debtor in property if certain conditions are met. Further, a trustee may avoid any transfer of an interest of the debtor in property made between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an "insider." 11 U.S.C. § 547(b)(4)(B). There are "two distinct types of insiders: 1) those entities specifically mentioned in the statute ('relative,' 'partnership,' 'general partner,' and 'corporation'), i.e. statutory or per se insiders, or 2) those not listed in the statutory definition, (non-statutory insider) but who have a 'sufficiently close relationship with the debtor that conduct is made subject to closer scrutiny than those dealing at arm's length with the debtor. The Court of Appeals held that creditor that, despite having a 10.6% equity interest in debtor-corporation and right to appoint its representative to debtor's board of directors, had not exercised any control or undue influence over debtor, and whose representative on debtor's board, by not participating in any vote that concerned debtor's payments to creditor, had exhibited sensitivity to potential conflicts of interest and acted to ensure that debtor's transactions with creditor were conducted at arm's length, could not be regarded as non-statutory insider based solely on closeness of relationship between parties. *Anstine v. Carl Zeiss Meditec AG (In re U.S. Medical, Inc.)* 531 F.3d 1272, 1276 (10th Cir. 2008).

Research references: Dunaway, The Law of Distressed Real Estate, § 34:75. Preferential transfers to insiders, 4 Norton Bankr. L. & Prac. 3d § 66:39, Chapter 66. Preferential Transfers (Code § 547)III. Insider Preferences (Code § 547(b)(4)) § 66:39. In general; Who Is "Insider" Within Meaning of Bankruptcy Code of 1978 (11 U.S.C.A. §§ 101 et seq.), 71 A.L.R. Fed. 197.

Third Circuit

Does a bankruptcy court have jurisdiction to hear a dispute even though it has not made a formal determination pursuant to 28 U.S.C.A. § 157(b)(3) that a proceeding is core or noncore?

Third Circuit rules that a bankruptcy court has jurisdiction to hear a dispute even though it has not made a formal determination pursuant to 28 U.S.C.A. § 157(b)(3) that a proceeding is core or noncore. Such a determination does not affect the court's power to hear the case, it only affects whether the court's disposition is final and appealable to the district court as a core proceeding or is a report and recommendation to the district court when noncore. *In re Mullarkey*, 536 F.3d 215, 221 (3rd Cir. (N.J.) Jul 31, 2008) (NO. 05-4081, 05-4651).

Plaintiff Mullarkey alleged a claim for fraud with regard to an asset of the estate that occurred during the administration of the bankruptcy case. The Bankruptcy Court in the instant case failed to make a determination whether the proceeding was a core proceeding before granting a dispositive motion and entering final judgment. The Court of Appeals had to decide whether the Code requires a bankruptcy court to explicitly determine, as a jurisdictional prerequisite, if a proceeding is core. Mullarkey argued that bankruptcy jurisdiction did not exist over his complaint, and that even if there was bankruptcy jurisdiction, the District Court erred in treating the matter as a core proceeding-allowing the Bankruptcy Court to enter a final judgment pursuant to 28 U.S.C. § 157 and applying a deferential standard of review in lieu of the required de novo review. Mullarkey further argued that his complaint should not have been dismissed on preclusion grounds, and that he may seek a civil remedy for the Defendants' violation of the federal RICO statute, 18 U.S.C. § 1964.

Courts in bankruptcy must satisfy themselves of subject matter jurisdiction. A bankruptcy court has subject matter jurisdiction over "all cases under title 11 and all core proceedings arising under title 11, or arising in a case under title 11, referred under subsection (a) of this section, and may enter appropriate orders and judgments, subject to review under section 158 of this title." 28 U.S.C. § 157(b)(1). Therefore, a bankruptcy court must make an initial determination that the claims before it fall within the purview of section 157 of Title 28. Once this determination has been made, § 157 invests two levels of authority in a bankruptcy judge depending upon which of the two categories a case or proceeding falls into. *In re Seven Fields Dev. Corp.*, 505 F.3d 237, 254 (3d Cir.2007) (citing 28 U.S.C. § 157). The two categories are (1) "all cases under title 11 and all core proceedings arising under title 11, or arising in a case under title 11,"28 U.S.C. § 157(b)(1) (collectively known as "core proceedings"), and (2) "a proceeding that is not a core proceeding but that is otherwise related to a case under title 11,"28 U.S.C. § 157(c)(1) ("non-core proceedings"). *Id.* (citations omitted). While it is clear that a bankruptcy court has jurisdiction over all proceedings "related to" a bankruptcy case, the core/non-core distinction is relevant to the scope of the bankruptcy court's powers upon referral: in core proceedings, the bankruptcy judge may issue final orders and judgments. *See* 28 U.S.C. § 157(b)(1). In non-core proceedings, the bankruptcy court's powers are more circumscribed: it must submit "proposed findings of fact and conclusions of law" to the district court, which enters an order only after conducting de novo review. *See* 28 U.S.C. § 157(c)(1). Thus, the core/non-core distinction is a critical one with respect to a bankruptcy court's adjudicative authority. Section, § 157(b)(3) states that:

> The bankruptcy judge shall determine, on the judge's own motion or on timely motion of a party, whether a proceeding is a core proceeding under this subsection or is a proceeding that is otherwise related to a case under title 11. . .

The courts are split on whether § 157(b)(3) is jurisdictional. The Fourth Circuit in *In re Johnson,* 960 F.2d 396, 400 (4th Cir.1992), pointed out that:

> [s]ome courts hold that failure of the bankruptcy court to make a § 157(b)(3) finding deprives the bankruptcy court of jurisdiction; and the failure of the parties to request the finding does not waive their right to later object that the finding was a necessary predicate to jurisdiction. *In re Wefco,* 97 B.R. 749, 750-51 (E.D.N.Y.1989) (failure to determine whether matter is core or non-core is not harmless error); *In re Marill Alarm Systems Inc.,* 81 B.R. 119, 122 (S.D.Fla.1987), aff'd sub nom. *Marill Alarm Sys. v. Equity Funding,* 861 F.2d 725 (11th Cir.1988) (not precedential) (if bankruptcy

judge enters final judgment without making determination under § 157(b)(3) it must be invalidated; failure of parties to move for determination does not waive error); *In re Nell,* 71 B.R. 305, 310 (D.Utah 1987) (same). Other courts hold that a party's failure to request a 157(b)(3) finding waives any objection to the lack of such finding. *In re Rath Packing Co.,* 75 B.R. 137, 138 (N.D.Iowa 1987), *aff'd sub nom. Rath Packing Co. v. United Food,* 860 F.2d 1086 (8th Cir.1988), *cited in* 1 Collier on Bankruptcy (MB) ¶ 3.01 at 3-52 (15th ed.1989); *Rainey v. International Harvester Credit Corp.,* 59 B.R. 987, 989-90 (N.D.Ill.1986). The Fourth Circuit was persuaded by the latter view, concluding that the lack of a jurisdictional finding under § 157(b)(3) does not deprive a bankruptcy court of jurisdiction. *In re Johnson,* 960 F.2d at 400 n. 2. The Court in *Mullarkey* agreed with the view adopted by the Fourth Circuit and held that the Bankruptcy Court was not deprived of jurisdiction over Mullarkey's complaint for failure to make the determination under § 157(b)(3).

Research references: Dunaway, The Law of Distressed Real Estate, § 28:8. Jurisdiction of bankruptcy and district courts—Bankruptcy courts.

Tenth Circuit B.A.P.

Does an action for willful violation of automatic stay survive dismissal of bankruptcy case?

Addressing an issue of apparent first impression for the court, an action for willful violation of the automatic stay survives dismissal of the main bankruptcy case. *Johnson v. Smith (In re Johnson)*390 B.R. 414 (B.A.P. 10th Cir. 2008).

Tenth Circuit

Can a Chapter 11 case be dismissed if debtor never submitted a reasonable plan or took steps to revive his business?

Chapter 11 provides that "the court shall convert a case under this chapter to a case under chapter 7 or dismiss a case under this chapter, whichever is in the best interests of creditors and the estate, if the movant establishes cause." 11 U.S.C. § 1112(b)(1). "[T]he term 'cause' includes-(A) substantial or continuing loss to or diminution of the estate and the absence of a reasonable likelihood of rehabilitation ... [and] (J) failure to file a disclosure statement, or to file or confirm a plan, within the time fixed by this title or by order of the court." *Id.* at § 1112(b)(4). The bankruptcy court determined that the trustee established sufficient cause: Debtor never submitted a reasonable plan or took steps to revive his business, so case was properly dismissed. Affirmed. *Vincens v. Convenience Plus Partners, LLC (In re Vincens)*No. 08-8014, Slip copy, 2008 WL 2855630 (Not Selected for publication in the Federal Reporter) (10th Cir. July 25, 2008).

Research references: Dunaway, The Law of Distressed Real Estate, § 28A:15. Conversion of cases from another chapter to Chapter 7 or dismissal—Conversion from Chapter 11 to Chapter 7—Discretionary conversion to Chapter 7 or dismissal: Code § 1112(b) in general—Continuing loss and absence of likelihood of reorganization: Code § 1112(b)(1).

Third Circuit

Can a Chapter 13 debtor invalidate a lien in the plan without commencing an adversary proceeding under Rule 7001?

Confirmed Chapter 13 plan did not invalidate lien when debtor failed to initiate an adversary proceeding against lienholder. *SLW Capital, LLC v. Mansaray-Ruffin (In re Mansaray-Ruffin)* 530 F.3d 230 (3d Cir. 2008). Provision in confirmed Chapter 13 plan treating mortgage assignee's lien as invalid could not be deemed final and controlling when debtor failed to pursue invalidity of lien through adversary proceeding required by Rule 7001(2), which established level of process to which assignee was entitled, under due process principles, before being deprived of its property interest in lien. Any actual knowledge that assignee had regarding plan's treatment of its lien did not eliminate its due process right to service of complaint and summons. U.S.C.A. Const.Amend. 5; 11 U.S.C.A. § 1327; Fed.Rules Bankr. Proc.Rule 7001(2), 11 U.S.C.A.

Research References: Dunaway, The Law of Distressed Real Estate § 30:80 (Effect of confirmation); Norton Bankr. L. & Prac. 3d 11 U.S.C. § 1327 (Effect of confirmation); Bankruptcy Law Manual 5d §§ 13:12, 13:44.

Priorities

Court of Appeals of Tennessee

Can the holder of a recorded deed of trust lose its priority because it is equitably estopped from asserting its deed of trust?

In this appeal, the Court of Appeals of Tennessee determined the priority between two recorded deeds of trust. Homeowners entered into a line of credit with a credit union secured by a recorded deed of trust on the homeowners' home. The homeowners subsequently refinanced their home with a bank. The bank paid off the homeowners' debt to the credit union, and recorded its own deed of trust securing its loan. At that same time, the loan and deed of trust was assigned to a second bank. Despite the payoff of the homeowners' debt by the assignor bank, the first deed of trust to the credit union was never released, and the homeowners continued to draw on the line of credit. When the homeowners began having financial problems, the assignee bank discovered that the credit union had never released its deed of trust on the homeowners' property because of a provision in the deed of trust stating that its release was conditioned upon the borrower requesting the cancellation of the line of credit. When the homeowners defaulted on both loans, the question arose as to which party's deed of trust had priority. The trial court ruled in favor of the assignee bank on the basis that the credit union was equitably estopped from asserting its deed of trust because, at the time of payoff, the credit union did not follow its self-imposed practice of advising if any action other than payoff was required before release of the deed of trust.

The Tennessee Supreme Court has restated the various elements that a plaintiff must establish in order to successfully invoke the doctrine of equitable estoppel as follows:

> The doctrine of equitable estoppel requires evidence of the following elements with respect to the party against whom estoppel is asserted:
>
> (1) Conduct which amounts to a false representation or concealment of material facts, or, at least, which is calculated to convey the impression that the facts are otherwise than, and inconsistent with, those which the party subsequently attempts to assert; (2) Intention, or at least expectation that such conduct shall be acted upon by the other party; (3) Knowledge, actual or constructive of the real facts.
>
> Equitable estoppel also requires the following elements with respect to the party asserting estoppel:
>
> (1) *Lack* of knowledge and *of the means of knowledge of the truth as to the facts in question;* (2) Reliance upon the conduct of the party estopped; and (3) Action based thereon of such a character as to change his position prejudicially.
>
> *Osborne v. Mountain Life Ins. Co.,* 130 S.W.3d 769, 774 (Tenn.2004) (citations omitted) (emphasis added).

The Court of Appeals reversed because it concluded that the assignor bank had the means of discovering that payoff alone was insufficient to trigger the release of the deed of trust and because, under state statutory law, it had prior notice of all prerequisites to release the deed of trust as a result of the credit union's registration of such deed. *Washington Mutual Bank, F.A. v. ORNL Federal Credit Union,* ___S.W.3d___, 2008 WESTLAW 2510587, *3 (Tenn. Ct. App. 6/24/08).

Research references: Dunaway, The Law of Distressed Real Estate, § 40:2. Overview: Determination of priorities, 4 Williston on Contracts § 8:3 (4th ed.)§ 8:3. Representations made enforceable by equitable estoppel (Westlaw WILLSTN-CN § 8:3). ■

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in the case." *Id.* Furthermore, "what may be acceptable in a commercial setting, where all of the entities are solvent and creditors are being paid, is not acceptable when those entities are insolvent and there are concerns about intercompany transfers and the preference of one entity and its creditors at . . . the expense of another." *In re Envirodyne*, 150 B.R. at 1018; *see also In re Amdura Corp.*, 121 B.R. 862, 866 (Bankr. D. Colo. 1990). A bankruptcy professional must be able to act in the best interests of the bankruptcy estate, free of any prior or ongoing commitments. *In re Envirodyne*, 150 B.R. at 1018. "Because of these limitations, a chapter 11 debtor does not have an absolute right to counsel of its choice." *Id.*

1. Disinterested Person

The term "disinterested person" is defined in section 101(14) of the Bankruptcy Code as a person that: (a) is not a creditor, an equity security holder, or an insider; (b) is not and was not, within 2 years before the date of the filing of the petition, a director, officer or employee of the debtor; and (c) does not have an interest materially adverse to the interest of the estate or any class of creditors or equity security holders, by reason of any direct or indirect relationship or connection with the debtor. 11 U.S.C. § 101(14). Courts disagree as to how strictly to apply the statute. Some courts find that any lack of disinterestedness results in automatic disqualification. *See In re Consolidated Bancshares, Inc.*, 785 F.2d 1249, 1256 n.6 (5th Cir. 1986). Other courts have held that section 327 does not dictate any "*per se* ban" or "general rule of simple application," but rather requires a "fact-specific" inquiry into the "parties' interests and their alignments." *Bank Brussels Lambert v. Coan (In re AroChem Corp.)*, 176 F.3d 610, 626 (2d Cir. 1999) (citation omitted).

2. Adverse Interest

Section 327(a) requires that, in addition to being disinterested, the professional retained by the trustee not hold or represent an interest adverse to the estate. Although the Bankruptcy Code does not define the phrase "hold or represent an interest adverse to the estate," many courts employ the definition developed by *In re Roberts*, 46 B.R. 815 (Bankr. D. Utah 1985), *aff'd in part and rev'd and remanded in part on other grounds*, 75 B.R. 402 (D. Utah 1987):

(1) to possess or assert any economic interest that would tend to lessen the value of the bankruptcy estate or that would create either an actual or potential dispute in which the estate is a rival claimant; (2) to possess a predisposition under circumstances that render . . . a bias against the estate.

See also In re AroChem Corp., 176 F.3d at 623; *Kravit, Gass & Weber, S.C. v. Michel (In re Crivello)*, 134 F.3d 831, 835-36 (7th Cir. 1998) (citation omitted); *Rome v. Braunstein*, 19 F.3d 58 n.1 (1st Cir. 1994); *In re eToys, Inc.*, 331 B.R. 176, 189 (Bankr. D. Del. 2005). "Stated another way, if it is plausible that another interest may cause the professional to act differently than they would without that other representation, then that professional would have a conflict and an interest adverse to the estate warranting disqualification." *In re WorldCom, Inc.*, 311 B.R. 151, 163-64 (Bankr. S.D.N.Y. 2004). An interest is not considered adverse, however, simply because it is possible to conceive of a situation where interests might clash. *See TWI Int'l, Inc. v. Vanguard Oil and Serv. Co.*, 162 B.R. 672, 675 (S.D.N.Y. 1994) (conflicts that are "hypothetical" or "theoretical" not basis for disqualification); *In re WorldCom, Inc.*, 311 B.R. at 168 (professional did not hold adverse interest "simply because there is a speculative possibility that in the future some events may render" professional and debtor adverse).

3. Section 327(c) – Exception to Adverse Interest

Under a strict reading of section 327(a) of the Bankruptcy Code, a debtor in possession could not retain a bankruptcy professional who concurrently represents a creditor of the debtor, if that creditor has an adverse interest. Section 327(c) of the Bankruptcy Code contains an exception to this disqualification and provides:

> In a case under chapter 7, 12, or 11 of this title, a person is not disqualified for employment under this section solely because of such person's employment by or representation of a creditor, unless there is objection by another creditor or the United States trustee, in which case the court shall disapprove such employment if there is an ***actual conflict of interest***.

11 U.S.C. § 327(c) (emphasis added). "Section 327(c) expresses the recognition that a prospective professional for a trustee may, fully consistent with the Code, have represented, or even continue to represent, one or more creditors." *In re Diva Jewelry Design, Inc.*, 367 B.R. 463, 470 (Bankr. S.D.N.Y. 2007); *see also* 3 Collier On Bankruptcy § 327.04[7][b] (Alan N. Resnick, et al. eds., 15th ed. rev. 2007) (noting that section 327(c) allows debtors "in large chapter 11 reorganization cases with widespread creditor interests" to obtain competent counsel even though counsel may represent certain creditors). Courts have found that an actual conflict of interest "is 'an active competition between two interests, in which one interest can only be served at the expense of the other.'" *Diva Jewelry Design, Inc.*, 367 B.R. at 472 (citing *In re Mercury*, 280 B.R. 35, 64 (Bankr. S.D.N.Y. 2002)).

4. Actual, Potential or Appearance of Conflict as Disqualifying under Section 327(c)

As a result of the various situations where conflicts may arise, courts have been unable to formulate a universal standard to determine whether a specific conflict requires disqualification. Thus, courts have differed as to whether a professional should be disqualified for only "actual" conflicts rather than "potential" conflicts, which do not presently exist but may in some circumstances become "actual." The differing views stem from the confusion surrounding section 327(c) of the Bankruptcy Code, which mandates disqualification for "actual" conflicts resulting from a professional representing both the bankruptcy estate and the creditor. Some courts rely on the term "actual" in section 327(c) of the Bankruptcy Code to distinguish actual from potential conflicts of interest. *See In re N.S. Garrott & Sons*, 63 B.R. 189, 192 (Bankr. E.D. Ark. 1986) (stating that professional may have conflicts recognized under section 327(c) that are non-disqualifying); *In re Roberts*, 46 B.R. at 838-39 (recognizing disqualification for actual conflicts, but not precluding disqualification for potential conflicts).

In *In re Marvel Entertainment Group, Inc.*, 140 F.3d 463, 476 (3d Cir. 1998), the Third Circuit set up the following three-step analysis:

(1) Section 327(a), as well as § 327(c), imposes a per se disqualification as trustee's counsel of any attorney who has an actual conflict of interest; (2) the district court may within its discretion—pursuant to § 327(a) and consistent with § 327(c)—disqualify an attorney who has a potential conflict of interest and (3) the district court may not disqualify an attorney on the appearance of conflict alone.

This approach appears to be consistent with the approach of the majority of courts and it permits the bankruptcy court a level of discretion and flexibility in considering the severity of a potential conflict. *See Magten Asset. Mgmt. Corp. v. Paul Hastings Janofsky & Walker LLP (In re Northwestern Corp.)*, 346 B.R. 84, 88 (D. Del. 2006) (explaining that that denomination of conflict as "potential" or "actual" and decision concerning whether to disqualify professional based upon that determination in situations not yet rising to level of actual conflict are matters committed to bankruptcy court's sound exercise of discretion).

B. Retention of Special Counsel Under Section 327(e)

An attorney's failure to be disinterested may prevent employment by the estate for general purposes. Nonetheless, the estate may retain the attorney for a "special purpose." Section 327(e) provides that the debtor, "with the court's approval, may employ, for a specialized purpose, other than to represent the [debtor] in conducting the case, an attorney that has represented the debtor, if in the best interest of the estate, and if such attorney does not represent or hold any interest adverse to the debtor or to the estate with respect to the matter on which such attorney is to be employed." Basically, section 327(e) allows a debtor to retain an attorney (but no other types of professionals) for a specialized purpose (*i.e.*, not serving as debtor's counsel to run the administration of the bankruptcy case) and relaxes the "disinterested person" requirement by requiring only that such attorney not be adverse in the matter for which the attorney was retained. Thus, a special counsel may be adverse to the debtor in other matters, such as holding a prepetition claim for outstanding fees or representing parties that are adverse to the debtor in matters unrelated to the section 327(e) retention. *See In re EBW Laser, Inc.*, 333 B.R. 351, 359 (Bankr. M.D.N.C. 2005) (counsel not disqualified under section 327(e) because it holds prepetition claim); *In re Albert*, 206 B.R. 636, 644 n.7 (Bankr. D. Mass. 1997).

C. Ordinary Course Professionals

If a professional's role in a bankruptcy case is relatively minimal, it may be retained as an "ordinary course professional" by the debtor. Typically in a large chapter 11 case, the bankruptcy court will approve procedures that allow the debtor to retain and pay professionals in the ordinary course of business without further court approval as long as the fees and expenses of such professionals do not exceed a monthly average of some fixed amount, such as $25,000. In addition, there is typically a requirement that any "ordinary course professional" providing legal or accounting services cannot receive payment for postpetition services rendered until such professional files an affidavit with the bankruptcy court setting forth, among other things, that such professional does not represent or hold any interest adverse to the debtors or their estates with respect to matters for which the professional will be retained.

D. Disclosure under Bankruptcy Rule 2014(a)

Bankruptcy Rule 2014(a) requires a professional seeking an order for employment in a bankruptcy case to submit a verified statement setting forth the professional's connections to the debtor, creditors and any other parties in interest, including their respective counsel and accountants. The purpose of Bankruptcy Rule 2014 is to provide the bankruptcy court (and the office of the United States trustee) with information to determine whether the professional's retention is in the best interests of the estate, *see In re Leslie Fay Cos., Inc.*, 175 B.R. 525, 533 (Bankr. S.D.N.Y. 1994), and to maintain the integrity of the bankruptcy system. *See In re Envirodyne*, 150 B.R. at 1021. Courts have ruled that Bankruptcy Rule 2014 disclosures are to be strictly construed, and the professional must disclose all facts that bear on disinterestedness and cannot usurp the court's functions by selectively incorporating materials the professional deems important. *See In re Granite Partners, L.P.*, 219 B.R. 22, 35 (Bankr. S.D.N.Y. 1998). Failure to disclose relevant connections is an independent basis for disallowance of fees or disqualification from the case. *See In re Leslie Fay*, 175 B.R. at 533. A professional has an ongoing responsibility to update its disclosures under Bankruptcy Rule 2014 as the circumstances warrant.

E. Preference Risk

Section 547(b) of the Bankruptcy Code allows a debtor to avoid as preferences any payments made to professionals on account of an antecedent debt (*i.e.*, outstanding invoices for services rendered) within the 90 day period prior to the petition date. As provided in section 547(c) of the Bankruptcy Code, potential defenses to a preference claim include: (i) the payment was made in the ordinary course of business; (ii) the professional provided new value subsequent to the transfer; or (iii) the payment was fully secured by a retainer. Because of this section of the Bankruptcy Code, a professional is not only at risk of being required to return payments that it received from the debtor, it may be determined to have failed the section 327 "disinterested" standard. As a consequence, the bankruptcy court could, in addition to directing the professional to return the preferential payments, disqualify the professional altogether and require it to disgorge all fees earned during the bankruptcy case. *See, e.g.*, *Staiano v. Pillowtex, Inc. (In re Pillowtex, Inc.)*, 304 F.3d 246, 253 (3d Cir. 2002).

F. Timing of Filing Retention Application and *Nunc Pro Tunc* Approval

Pursuant to section 327 of the Bankruptcy Code, professionals cannot be retained by the debtor, and thus paid, until their retention is approved by the bankruptcy court. Accordingly, any fees incurred by a professional prior to the effective date of the order authorizing retention cannot be reimbursed. It is therefore crucial that the retention application be filed as quickly as possible.

Because there is a lag between the time when the retention application is filed and when it is approved by the bankruptcy court, professionals often request retroactive, or *nunc pro tunc*, approval of their retention. Bankruptcy courts generally will grant *nunc pro tunc* approval to the date that the application is filed. If the applicant is seeking *nunc pro tunc* approval to a date earlier than the date the application was filed, however, bankruptcy courts may not grant the request. Accordingly, any fees incurred during a bankruptcy case prior to the date of filing of the retention application may not be approved.

Recognizing, however, that retention applications take some time to prepare and that often there are more pressing matters, particularly in the first few days of a chapter 11 case, bankruptcy courts have given professionals some leeway in filing their applications later than the first day of the bankruptcy case. Some courts, though, have adopted an absolute rule that the *nunc pro tunc* period cannot exceed 30 days prior to the time the retention application was filed. Bottom line, professionals retained as of the petition date should endeavor to file their retention applications on the first day of the case; if this is not possible, the application should be filed as soon as possible thereafter, and in no event should it be filed more than 30 days after the petition date.

G. Compensation Arrangements Under Section 328(a)

Under section 328(a) of the Bankruptcy Code, professionals may be employed pursuant to prearranged terms of compensation. With court approval, professionals may be employed on any reasonable terms and conditions, including "on a retainer, on an hourly basis, on a fixed or percentage fee basis, or on a contingent fee basis." 11 U.S.C. § 328(a). Financial advisors and investment bankers often seek approval under section 328(a), in part, because the compensation structures typically used by these professionals differ from the more established "time-clock" approach adopted by most attorneys. Significantly, section 328(a) limits the ability of a court to modify the compensation agreement once it has been approved. The subsection permits a court to allow compensation different from the compensation it previously approved only if the terms of the agreement prove to be "improvident" in view of circumstances that were "not capable of being anticipated" at the time the agreement was approved. *See Nischwitz v. Miskovic (In re Airspect Air, Inc.)*, 385 F.3d 915 (6th Cir. Ohio 2004); *Donaldson Lufkin & Jenrette Sec. Corp. v. National Gypsum Co. (In re National Gypsum Co.)*, 123 F.3d 861 (5th Cir. 1997).

III. Allowance of Compensation and Reimbursement of Expenses

A retained professional must seek bankruptcy court approval of its fees and expenses pursuant to the Bankruptcy Code, the Bankruptcy Rules and any applicable Local Rules in order to receive payments from the estate.

A. Section 330(a)(1)

Section 330(a)(1) of the Bankruptcy Code provides that, after notice to parties in interest and to the United States trustee, the bankruptcy court may award payments of

(A) reasonable compensation for actual, necessary services rendered by the trustee, examiner, ombudsman, professional person, or attorney and by any paraprofessional person employed by any such person; and

(B) reimbursement for actual, necessary expenses.

Section 330(a)(3)(A) further provides the following standards for the Court's review of fee applications:

In determining the amount of reasonable compensation to be awarded, the court shall consider the nature, the extent, and the value of such services, taking into account all relevant factors, including–

(A) the time spent on such services;

(B) the rates charged for such services;

(C) whether the services were necessary to the administration of, or beneficial at the time the service was rendered toward the completion of, a case under this title;

(D) whether the services were performed within a reasonable amount of time commensurate with the complexity, importance, and nature of the problem, issue, or task addressed; and

(E) whether the compensation is reasonable, based on the customary compensation charged by comparably skilled practitioners in cases other than cases under this title.

11 U.S.C. § 330(a)(3)(A).

Basically, to grant a request for allowance of compensation or reimbursement of expenses pursuant to section 330 of the Bankruptcy Code, a court must find that the request is reasonable and that the services provided or expenses incurred were actual and necessary. The reasonableness of a compensation request is determined by taking into account the nature, extent and value of the services provided by the professional and the cost of comparable services in nonbankruptcy contexts. *See Zolfo Cooper & Co. v. Sunbeam-Oster Co.*, 50 F.3d 253, 258 (3d Cir. 1995). The legislative history of section 330 of the Bankruptcy Code explains the need to provide for compensation comparable to other nonbankruptcy services:

The effect of [section 330] is to overrule . . . cases that require fees to be determined based on notions of conservation of the estate and economy of administration. If [those] cases were allowed to stand, attorneys that could earn much higher incomes in other fields would leave the bankruptcy arena. Bankruptcy specialists, who enable the system to operate smoothly, efficiently, and expeditiously, would be driven elsewhere, and the bankruptcy field would be occupied by those who could not find other work and those who practice bankruptcy law only occasionally almost as a public service.

H.R. Rep. No. 595, 95th Cong., 1st Sess. 329-30 (1977); *see also* 124 Cong. Rec. S17, 408 (daily ed. Oct. 6, 1978). The perspective from which an application for an allowance of compensation should be viewed in a reorganization case was stated by Congressman Edwards on the floor of the House of Representatives on September 28, 1978, when he made the following statement in relation to section 330 of the Bankruptcy Code:

[B]ankruptcy legal services are entitled to command the same competency of counsel as other cases. In that light, the policy of this section is to compensate attorneys and other professionals serving in a case under title 11 at the same rate as the attorney or other professional would be compensated for performing comparable services other than in a case under title 11. . . . [N]otions of economy of the estate in fixing fees are outdated and have no place in a bankruptcy code.

124 Cong. Rec. H11,091-92 (daily ed. Sept. 28, 1978) (statement of Rep. Edwards); *see also In re McCombs*, 751 F.2d 286 (8th Cir. 1984); *In re Carter*, 101 B.R. 170 (Bankr. D.S.D. 1989); *In re Public Serv. Co. of New Hampshire*, 93 B.R. 823, 830 (Bankr. D.N.H. 1988); *In re White Motor Credit Corp.*, 50 B.R. 885, 890 (Bankr. N.D. Ohio 1985).

B. Bankruptcy Rule 2016.

Additional guidelines for the application for compensation are set forth in Bankruptcy Rule 2016(a). Basically, Bankruptcy Rule 2016 requires that a fee application contain a detailed statement of the services rendered, time expended and expenses incurred.

C. Section 331

Section 331 of the Bankruptcy Code permits a trustee, an examiner, an attorney or any professional person to apply to the court for interim allowance of compensation and reimbursement of expenses for services rendered before the date of the fee application. In many cases, courts have permitted payments to be made on a monthly basis, subject to the filing of applications for compensation on a quarterly basis.

IV. Indemnification and D&O Insurance After a Bankruptcy Filing

A professional employed as an officer of a debtor faces certain risks in seeking indemnification from the debtor or accessing a debtor's D&O insurance policy.

A. Indemnification Obligations

As a general matter, absent specific authorization from the bankruptcy court, a debtor in possession is generally prohibited from making payments on indemnification claims based on prepetition acts. *See, e.g., In re Mid-American Waste Sys., Inc.*, 228 B.R. 816, 821-22 (Bankr. D. Del. 1999); *In re Pinnacle Brands, Inc.*, 259 B.R. 46, 51 (Bankr. D. Del. 2001). Accordingly, if a professional has been employed as an officer prepetition and litigation against directors and officers has already been commenced by the time of a bankruptcy filing or is commenced after the filing, but relates to prepetition acts, the debtor's ability to advance expenses or otherwise indemnify the directors and officers will cease. Professionals employed pre-bankruptcy are not left, however, without protections or resources.

Although, in general, the filing of a bankruptcy petition only stays litigation of claims against the debtor, a bankruptcy court may stay litigation against directors and officers on the theory that (i) claims against the directors and officers are similar to those against the company and if permitted to proceed, would effectively circumvent the automatic stay, *see, e.g.*, *A.H. Robins Co. v. Piccinin*, 788 F.2d 994, 1002 (4th Cir.), *cert. denied*, 479 U.S. 876 (1986), or (ii) the directors and officers are needed to operate the company during the reorganization and should not be distracted by such a claim. *See, e.g.*, *Nevada Power Co. v. Calpine Corp. (In re Calpine Corp.)*, 365 B.R. 401, 410 (S.D.N.Y. 2007); *Homestead Holdings, Inc. v. Broome & Wellington (In re PTI Holding Corp.)*, 346 B.R. 820, 827 (Bankr. D. Nev. 2006); *In re M.J.H. Leasing, Inc.*, 328 B.R. 363, 368-69 (Bankr. D. Mass. 2005); *Lomas Fin. Corp. v. Northern Trust Co. (In re Lomas Fin. Corp.)*, 117 B.R. 64, 66-67 (S.D.N.Y. 1990). Courts have typically only been willing to extend the stay to directors and officers who are integral to the restructuring process and only for a specified period of time.

Moreover, post-petition defense costs are generally covered by the D&O insurer, subject to any deductible and the risks discussed below. To the extent that the expenses are not paid by the insurer, a debtor may seek authorization from the bankruptcy court to pay the defense costs, and bankruptcy courts have in certain circumstances granted those requests, albeit sometimes subject to a dollar limitation. Where the directors and officers are accused of breaching the duty of loyalty or committing fraud, court approval of a request to advance defense costs is less likely.

Finally, the plan of reorganization ultimately confirmed in the bankruptcy case may provide for the assumption by the debtor of its obligations to indemnify directors and officers who served in those roles during the bankruptcy case, enabling the debtor to fully honor its indemnification obligations even for claims arising from prepetition acts. Any director or officer not covered by the assumption would, however, retain his or her rights under the D&O insurance and would also have the right to file a claim for any unpaid indemnification obligation. That claim, however, would be treated as a general unsecured claim against the bankruptcy estate.

B. D&O Insurance Policies

1. Policy Proceeds as Property of the Estate

Outside of chapter 11, there generally is no question that proceeds of a D&O policy are available for the directors and officers, both for insurable losses and for litigation costs. Inside chapter 11, however, creditors have from time to time attempted to prevent directors and officers from accessing, and thereby depleting, the D&O policy proceeds in order to preserve the policy for the benefit of the estate. To date, these efforts have been largely unsuccessful, but certain terms of standard D&O policies may increase the likelihood that D&O coverage will not be available for the primary insureds, the directors and officers.

Many contemporary D&O policies contain three separate coverages: (a) "Side A" coverage that protects directors and officers for claims made directly against them; (b) "Side B" or "indemnity" coverage that protects corporations for amounts they pay to indemnify directors and officers; and (c) "entity coverage" that insures a corporation's own losses and, in the case of public companies, covers losses arising from securities claims.

Entity coverage has to some degree created potential obstacles to directors and officers accessing Side A coverage when their companies are in bankruptcy. Specifically, the existence of entity coverage has in some circumstances caused courts to find that D&O policy proceeds belong to the estate of a bankrupt corporation, thus requiring a bankruptcy court's blessing before directors and officers receive benefits under the coverage.

Unlike other insurance policies purchased by a corporation, the benefit of a D&O policy generally inures to the directors and officers personally. Consequently, if a D&O policy contains only Side A coverage, most courts would agree that the D&O policy proceeds do not belong to the bankruptcy estate. *See In re Louisiana World Exposition, Inc.*, 832 F.2d 1391, 1399 (5th Cir. 1987). The reality, however, is that most D&O policies cover not only the individual directors and officers vis-à-vis their Side A coverage, but also cover corporations themselves through Side B or entity coverage. If a corporation possesses Side B or entity coverage, it becomes more difficult to conclude that the corporation has no interest in the proceeds of a D&O policy such that the proceeds should not be treated as property of the estate. This is because most D&O policies contain an aggregate policy limit and, as a result, each dollar paid to a director or officer under Side A of the D&O policy reduces the amount of coverage available to the corporation under the corporation's Side B or entity coverage.

The courts are split as to whether D&O policy proceeds belong to the bankruptcy estate if the corporation possesses Side B or entity coverage. If a policy contains Side B but no entity coverage, the majority of courts have held that the policy proceeds do not belong to the bankruptcy estate. *See, e.g.*, *In re Allied Digital Technologies Corp.*, 306 B.R. 505, 512 (Bankr. D. Del. 2004); *In re Youngstown Osteopathic Hosp. Ass'n*, 271 B.R. 544, 550-52 (Bankr. N.D. Ohio 2002); *but see Exec. Risk Indem. v. Boston Reg'l Med. Ctr. (In re Boston Reg'l Med. Ctr., Inc.)*, 285 B.R. 87, 91-92 (Bankr. D. Mass. 2002); *In re Sacred Heart Hosp.*, 182 B.R. 413, 421 (Bankr. E.D. Pa. 1995); *In re Circle K Corp.*, 121 B.R. 257, 261 (Bankr. D. Az. 1990). The premise of these cases is generally that even though a D&O policy contains indemnity coverage along with Side A coverage, the policy is still at its core a "safeguard of officer and director interests and not a vehicle for corporate protection." *First Central Financial Corp.*, 238 B.R. 9, 20 (E.D.N.Y. 1999).

If a corporation possesses entity coverage, however, some courts have held that the proceeds of the corporation's D&O policy belong to the bankruptcy estate of the corporation. *See, e.g.*, *In re Tom's Foods, Inc.*, 2006 Bankr. LEXIS 3319, at *7 (Bankr. M.D. Ga. Dec. 7, 2006); *In re Arter & Hadden, L.L.P.*, 335 B.R. 666, 674 (Bankr. N.D. Ohio 2005); *In re Cybermedica, Inc.*, 280 B.R. 12, 17 (Bankr. D. Mass. 2002). These courts generally reason that because of the entity coverage, the bankruptcy estate is worth more with the D&O policy proceeds than it is worth without the proceeds. These cases have so held without regard to whether the corporation had made, or was likely to ever make, a claim against its entity coverage. Other courts, however, have held that the mere existence of entity coverage without a showing regarding the likelihood of a claim against the entity coverage is not enough to render policy proceeds property of the estate. *See, e.g., In re Adelphia Communs. Corp.*, 298 B.R. 49, 53-54 (S.D.N.Y. 2003); *In re First Central*, 238 B.R. at 20.

Although some cases have found that D&O policy proceeds are property of the estate, it is important to note that such a finding does not preclude a professional retained as an officer of the debtor from obtaining benefits under the policy. The professional may still petition the bankruptcy court to permit him or her to access the coverage, and bankruptcy courts have in some cases granted the request, although, at times, subject to a cap. *See, e.g., In re Tom's Foods, Inc.*, 2006 Bankr. LEXIS 3319, at *7; *Cybermedica*, 280 B.R. at 17; *In re Boston Reg'l Med. Ctr., Inc.*, 285 B.R. at 87.

2. Effect of Denial of Recourse Against D&O Policy

If a bankruptcy court determines that the D&O policy is unavailable to directors and officers, a professional's only recourse for an indemnification claim based on prepetition conduct would be to file claims against the debtor for his or her reimbursable costs and expenses. If the debtor has also been sued (or is jointly liable with the directors and officers), section 502(e) of the Bankruptcy Code would govern the allowance or disallowance of the prepetition claims. 11 U.S.C. § 502(e).[1]

1 Section 502(e) provides in relevant part:
Notwithstanding subsections (a), (b), and (c) of this section and paragraph (2) of this subsection, the court shall disallow any claim for reimbursement or contribution of an entity that is liable with the debtor on or has secured the claim of a creditor, to the extent that—
(A) such creditor's claim against the estate is disallowed;
(B) such claim for reimbursement or contribution is contingent as of the time of allowance or disallowance of such claim for reimbursement or contribution; or
(C) such entity asserts a right of subrogation to the rights of such creditor under section 509 of this title.
11 U.S.C. § 502(e)(1).

Section 502(e) would disallow these reimbursement claims to the extent they remained contingent at the conclusion of the claims allowance process. 11 U.S.C. § 502(e)(1)(B). This would in most cases leave the professional with no right to reimbursement from any source (whether the debtor or the insurer).

Even if the indemnification claims of the professional arising from prepetition acts are not contingent (or the debtor is not jointly liable with the them),[2] the professional may still be unable to recover any significant portion of his or her expenses and losses, if any. First, the indemnification claims, at best, would be treated as general, unsecured claims, which may be entitled to little or no recovery. Second, depending on the nature of the underlying lawsuit, the claims may be subject to subordination under section 510(b)[3]

2 This would make section 502(e)(1) not applicable.

3 Section 510(b) provides:
For the purpose of distribution under this title, a claim arising from rescission of a purchase or sale

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of the Bankruptcy Code. That section provides that a claim for reimbursement arising from the rescission of a purchase or sale of a security of the debtor shall be subordinated to all claims that are senior to or equal to the claims or interests represented by the debtor's security. Courts have used this provision to "subordinate indemnification claims of officers, directors and underwriters for both liability and expenses incurred in connection with the pursuit of claims for rescission or damages by purchasers and sellers of the debtor's securities." *In re Mid-Am. Waste Sys., Inc.*, 228 B.R. 816, 824 (Bankr. D. Del. 1999); *In re Public Serv. Co.*, 129 B.R. 3, 5 (Bankr. D.N.H. 1991). The net effect of subordination would be that the professional would only receive a recovery on his or her indemnification claims if unsecured creditors are satisfied in full.

3. "Insured vs. Insured" Exclusion

Besides having to overcome potential property of the estate arguments, a professional employed as an officer faces an additional hurdle in accessing a D&O policy. A bankruptcy trustee, debtor in possession, unsecured creditors' committee, or liquidating trustee may decide to sue the directors and officers on behalf of the debtor. This type of suit may implicate the "insured v. insured" exclusion of a D&O policy. This exclusion exempts from coverage claims that are brought by one insured against a coinsured. The purpose behind this exclusion is to prevent collusive lawsuits. *See Township v. Center Butler County Pa. v. First Mercury Syndicate, Inc.*, 117 F.3d 115, 119 (3d Cir. 1997) ("The primary focus of the exclusion is to prevent collusive suits . . . . [W]here, however, it is clear that the underlying action is not collusive, the exclusion has not precluded coverage.").

Although it would seem that there is little risk of collusion where a trustee, committee or court- or plan-appointed agent sues the directors and officers, there is inconsistent law on whether an "insured v. insured" exclusion would lead to a denial of coverage in such situations. Some courts have determined that such an exclusion would apply to bar coverage for an action by a trustee or postconfirmation liquidating trustee. *See, e.g., Nat'l Union Fire Ins. Co. v. Olympia Holding Corp.*, 1996 U.S. Dist. LEXIS 22806, at *23 (N.D. Ga. June 4, 1996) (action brought by trustee barred by exclusion), *affirmed without opinion, Nat'l Union Fire v. Olympia Holding*, 148 F.3d 1070 (11th Cir. 1998); *Reliance Ins. Co. v. Weis*, 148 B.R. 575 (E.D. Mo. 1992) (action brought by plan committee barred by exclusion), *aff'd*, 5 F.3d 532 (8th Cir. 1993), *cert. denied sub nom. Plan Comm. of Bank Bldg. & Equip. Corp. of Am. v. Reliance Ins. Co.*, 510 U.S. 1117 (1994). There have, however, been contrary rulings. *See, e.g., Alstrin v. St. Paul Mercury Ins. Co.*, 179 F. Supp. 2d 376 (D. Del. 2002) (insured versus insured exclusion did not apply because bankruptcy estate was separate entity from insured company); *Cohen v. Nat'l Union Fire Ins. Co. (In re County Seat Stores, Inc.)*, 280 B.R. 319, 327-29 (Bankr. S.D.N.Y. 2002) (bankruptcy trustee not subject to "insured vs. insured" exclusion because "trustee is a legal entity separate and distinct from the debtor"); *Rieser v. Baudendistel (In re Buckeye Countrymark, Inc.)*, 251 B.R. 835, 841 (Bankr. S.D. Ohio 2000) (same); *Pintlar Corp. v. Fidelity & Cas. Co. (In re Pintlar Corp)*, 205 B.R. 945, 947-48 (Bankr. D. Idaho 1997) (litigation trust not subject to "insured vs. insured" exclusion), *rev'd on other grounds*, 124 F.3d 1310 (9th Cir. 1997).

In light of the scant and split authority addressing the "insured v. insured" exclusion, it is uncertain whether a suit brought by a corporate debtor or a successor thereto against its directors and officers would be subject to this exclusion. It would seem that the danger that this exclusion is aimed at preventing, *i.e.*, collusion, is not present in situations where a bankruptcy trustee or other successor of the debtor attempts to hold directors and officers accountable for their behavior. Nonetheless, the risk remains that a court may determine that, because of the exclusion, no coverage is available to the professional.

4. Potential Solutions

Once a corporation files for bankruptcy, it may be too late to address problems with D&O coverage. Upon filing bankruptcy, a corporate debtor will probably not be able to make changes to its D&O policy without obtaining court approval, which may not be granted. Considering that much is at stake when D&O coverage is denied, a professional retained in a management role should consider taking proactive measures prior to a possible chapter 11 filing in order to address potential coverage problems in bankruptcy.

The professional should scrutinize the policy to determine, among other things, the nature of coverages included in the D&O insurance policy. If the policy includes Side B and entity coverage, the professional should ask the company to buy additional D&O insurance that would cover only Side A claims, *i.e.*, non-indemnifiable claims. Alternatively, the professional could ask the company to insist on a payment endorsement in the existing policy that would grant Side A claims first priority ahead of Side B and entity coverage claims or the inclusion of a provision allocating the payments under Side A, Side B and entity coverage by, in essence, dividing the total policy proceeds among the three types of coverage. Finally, the professional should ask the company to seek to amend its D&O policy to provide that the "insured v. insured" exclusion would not apply in the event of a bankruptcy filing. If the company is unwilling or unable to purchase new insurance or amend its existing insurance to mitigate the coverage risks, the professional should consider seeking separate coverage. ■

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of a security of the debtor or of an affiliate of the debtor, for damages arising from the purchase or sale of such a security, or for reimbursement or contribution allowed under section 502 on account of such a claim, shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security, except that if such security is common stock, such claim has the same priority as common stock.
11 U S.C. § 510(b).

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