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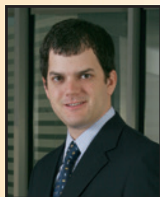
Rights Offerings in Bankruptcy: More Than New Capital

Daniel P. Winikka
Jones Day



Paul M. Green
Jones Day

Over the past decade, rights offerings have become a valuable and frequently used source of exit financing for chapter 11 debtors. The increased use of rights offerings is, in part, a result of the increased participation of non-traditional, sophisticated lenders in the bankruptcy process. Rights offerings are often beneficial to all parties involved. The debtor can obtain access to new capital without resorting to secured financing, and creditors or pre-bankruptcy equity security holders can preserve their investment in the debtor and obtain enhanced recoveries by investing at a discount to the perceived value of the reorganized company. Moreover, a successful rights offering can provide a signal to the market that there is healthy optimism in the success of the reorganized company.

In addition to providing reorganized debtors with access to new capital, rights offerings are increasingly being used as a tool to effectuate other agendas in a bankruptcy case, including the resolution of valuation disputes and allocating control of the new company.

The Basics of Rights Offerings

In bankruptcy, a rights offering allows a debtor to offer creditors or equity security holders the right to purchase equity in the post-emergence company, usually at a healthy discount to the assumed value of the reorganized enterprise. The class of creditors or equity security holders solicited for participation is generally offered the right to purchase their pro-rata share (i.e., the same percentage that their current holdings represent) of the equity available under the offering. Rights offerings typically involve a solicitation of the eligible creditors or equity security holders either in connection with solicitation of the reorganization plan or following confirmation of a plan but prior to consummation of the plan and emergence from bankruptcy. Because the new equity typically is sold at a discount to assumed value, parties often have a strong incentive to participate in the offering to avoid dilution, provided that they believe the offering price does in fact represent a discount to the value of the reorganized entity.

To guarantee the reorganized debtor's capital needs are met, rights offerings are usually backstopped by a third party that agrees to purchase any unsubscribed shares. Because the debtor's plan of reorganization is normally premised upon raising the financing contemplated by the rights offering, obtaining a backstop commitment is typically critical to establish the feasibility of the plan at confirmation and to avoid the possibility of a substantial loss of time and expense soliciting and confirming a plan that is thereafter never consummated because sufficient funds are not raised. Because there is always the inherent risk that the backstop party could be required to purchase a much larger number of unsubscribed shares than the party desires, backstop parties typically require payment of a backstop fee, often ranging from three to seven percent of the total offering. The backstop party will also typically want assurance, through an overallotment right or otherwise, that it will have the opportunity to purchase a certain minimum number of shares. To ensure its protection, the backstop party will require that, prior to proceeding with any solicitation of the rights offering, the debtor seek court approval of the backstop agreement, including the backstop fee. The backstop party can often end up with a controlling, or at least very influential, equity block. To obtain the most favorable terms, debtors often shop the backstop right, sometimes through an informal auction process.

One of the most heavily negotiated terms of the backstop agreement will be any material adverse change provision. There can often be months between the time the backstop agreement is signed and consummation of the rights offering, and it can be challenging to define, and reach agreement on, what unexpected adverse developments might permit the backstop party to terminate the backstop commitment.

A rights offering may include oversubscription or overallotment rights. Oversubscription rights allow existing creditors or equity holders to

Rights Offering continues on p. 14

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Baxter Dunaway - Section Editor
Jack Williams - Scholar in Residence
Forrest Lewis - Section Editor
Kenji Mochizuki - Section Editor

Letter from the President

Stephen Darr, CIRA, CDBV, CPA
Mesirow Financial Consulting LLC

On November 5, 2010, the ABI's Seventh Corporate Restructuring Competition was held at the Wharton School in Pennsylvania. Twelve teams with more than 40 team members from the nation's leading business schools participated in the competition. Each team was remarkably knowledgeable about restructuring issues, each presentation was terrific and each team member stood out as someone we all would be glad to work with.

For the first time, AIRA made a significant contribution to this competition by developing the case.

Medford Lumber Company was a hypothetical distressed company invented for the competition. The bankruptcy issues went far beyond a simple restructuring– the teams had to consider issues such as substantive consolidation, valuation, executory contracts and cramdown.

Competitors had one week to submit written materials identifying and analyzing the case and presenting a recommended course of action. The written materials were expected to address valuation issues, debt capacity, a five-year business plan supported by full financial statement projections, a 13 week cash flow and, of course, a proposed course of action..

On the morning of November 5, each competing team made two oral presentations to teams of judges acting as Medford's noteholders and its bank. Scoring was based on accuracy, organization, creativity, strategy and, of course, persuasiveness and delivery of the oral presentations. The top three teams then made final presentations to Medford's board of directors.

Columbia won the competition, Harvard was second and the University of Virginia-Darden came in third

AIRA had complete responsibility for the development of the Medford Lumber case. This was a major effort and consisted of a case write-up that was 38 pages long plus full historical financial statements for 5 years (on both a consolidated and a consolidating basis) as well as debt amortization schedules and other financial data needed to make the analysis.

The Medford Lumber case will also be used as the basis of ABI's September, 2011 Complex Financial Restructuring Program.

Developing this case was a major effort. **Tom Morrow, Becky Roof** and **Bryan Gaston** of Alix Partners, **Christine Wu McDonagh** of FTI and **Will Sugden** of Alson+Bird, as well as many others, worked very, very hard at this project and I know we all appreciate their efforts.

AIRA will continue its partnership on this competition with ABI as a result of this year's success. When the development team is formed for next year, please participate in what is sure to be a rewarding and exciting event. ■

Steve Darr is a Senior Managing Director of Mesirow Financial Consulting's Boston office, providing financial consulting services to businesses experiencing significant financial and operating difficulties, typically with deteriorating relationships with creditors and suppliers. Mr. Darr has served DIPs, secured and unsecured creditors, bondholders and others, and as interim management in various industries.

Executive Director's Column

Grant Newton, CIRA
AIRA Executive Director

Cost of Capital: Applications and Examples, 4th Edition

In the last issue of the AIRA Journal, I reviewed a new book by Shannon Pratt and Roger Grabowski titled *Cost of Capital in Litigation,* including a chapter in that book on "Cost of Capital in Bankruptcy." In the limited space available in this column, I would like to briefly comment on a new chapter appearing in the latest edition of another book by the same authors, *Cost of Capital: Applications and Examples,* which has been extremely well received by the valuation profession. *Cost of Capital: Applications and Examples 4th Edition* (published by John Wiley) is a major expansion containing several new parts that are especially helpful in valuing distressed companies. An expanded workbook and technical supplement is also available.

Those of you who attended AIRA's annual conference in San Diego may remember Roger's comments on estimating the equity risk premium considering the recent economic crisis: there is an expanded discussion of this topic in the new edition. A new chapter (Chapter 16) has been added on estimating the cost of capital for distressed businesses and valuation of companies emerging from bankruptcy. Comments in Chapters 16 and 18 provide guidance on how to deal with changes in capital structure that often result when distressed companies continue to be over-levered on emergence from chapter 11. Chapter 16 also contains an expanded discussion of the Duff and Phelps risk study (originally authored by David King–now with Mesirow–and Roger Grabowski) identifying high-financial-risk portfolios based on Altman's z-score. Other features of the 4th edition include expanded materials on estimating cost of debt and detailed pros and cons of including company-specific risk in the cost of equity. Copies of the Cost of Capital, *Cost of Capital Work Book and the Cost of Capital in Liquidation* are available from AIRA at a 20 percent discount.

I wish all of you the best in 2011—Grant

Chief Judge Arthur J. Gonzalez Receives 2010 AIRA Judicial Service Award

The Honorable Arthur J. Gonzalez of the United States Bankruptcy Court for the Southern District of New York has been named as the recipient of the 2010 AIRA Judicial Service Award. The award was presented to Chief Judge Gonzalez by AIRA President Steve Darr during a ceremony and reception at AIRA's 9th Annual Advanced Restructuring & Plan of Reorganization Conference, November 15, 2010, at the Union League Club in New York City.

The Judicial Service Award is presented to honor a Judge whose life and practice display strong character and unquestioned integrity, coupled with ongoing dedication to the highest standards in the Bankruptcy & Restructuring profession. Candidates are nominated and selected by a panel including AIRA Board of Director members and industry professionals.

In February of 2010, Judge Gonzalez was named Chief Judge of the U.S. Bankruptcy Court for the Southern District of New York. The Dean of Fordham University School of Law, William Treanor, described Judge Gonzalez as "a man of great character, outstanding principle, and remarkable talent." Judge Gonzalez has almost twenty years of experience on the bench and has presided over many high-profile financial cases, evincing an impressive and thorough understanding of even the most complex aspects of financial law. His most notable cases include Enron (2001), WorldCom (2002), and Chrysler (2009). At the time of the Chrysler bankruptcy, his peers and associates commended his appointment, describing him as wise, patient, fair, straight as an arrow, extremely bright and very calm even during heated discussions.

Born in Brooklyn and educated in the Bronx, where he received an accounting degree at Fordham in 1969, Judge Gonzalez worked as a science teacher in New York public schools for 13 years, earning his law degree from Fordham Law School in 1982 and an advanced degree in taxation from New York University in 1990. Working as an attorney in the Office of Chief Counsel of the Internal Revenue Service, he earned the Chief Counsel's Special Achievement Award for three consecutive years. Thereafter, he practiced with the firms of Pollner, Mezan, Stolzberg, Berger & Glass, P.C. and Gaston & Snow in New York City. First appointed to the Southern District in 1991 as an Assistant United States Trustee, two years later he was serving as United States Trustee for the Second Circuit and in 1995 he was appointed to the U.S. Bankruptcy Court for the Southern District. ■

AIRA Scholar in Residence

Jack F. Williams, CIRA, CDBV
Georgia State University College of Law

BANKRUPTCY RETAKES

Ponzi Schemes: Part III

This is my third column on Ponzi schemes. The first column focused on the original Ponzi scheme, crafted by Charles Ponzi, the characteristics of a Ponzi scheme, and the forensic challenges that such schemes present. The second column addressed the structure and psychology behind Ponzi schemes. In this column, I will consider some of the legal and proof issues associated with Ponzi schemes in bankruptcy.

Generally, Ponzi schemes present several forensic investigatory and legal questions. First, by its nature, a Ponzi scheme involves a fraudster with little or no reliable financial information. Second, what information you may find in a forensic investigation may be fraudulent. Thus, reliance on information from third-party sources, such as banks, etc., is generally necessary. Third, monies out may be difficult to trace and recover. Fourth, a bankruptcy trustee often finds himself with sympathetic investors (honest folks that have lost their savings) on one side, and sympathetic transferees (educational and charitable institutions), on the other. The dynamics make for some unpleasantness.

Like with many developments in a bankruptcy case, legal issues often drive forensic tasks, such as accounting, finance, interviewing, and the like. In the Ponzi world, fraudulent transfer law and distributional schemes are the two most often central to our role in understanding what happened.

Once the fraudster or his creditors in an involuntary case file a bankruptcy petition, the case commences under the United States Bankruptcy Code ("Bankruptcy Code" or "Code") like most any other.[1] In contrast with an SEC Receivership process, bankruptcy cases focus on fairness to all stakeholders, particularly holders of claims, and permit a trustee to employ fraudulent transfer and preference law to avoid certain distributions, redemptions, or payments made to various creditors or investors. Additionally, courts have ruled that a bankruptcy court may "stay the [related claims] proceedings pending the outcome of the bankruptcy proceeding."[2]

A trustee, or debtorinpossession under a chapter 11 case, may avoid any fraudulent transfer under § 548(a) of the Code.[3] The Bankruptcy Code recognizes two types of fraudulent transfers. The first type is commonly referred to as an actual fraudulent transfer. An actual fraudulent transfer is a transfer made by the debtor with the actual intent to hinder, delay, or defraud its creditors. With this type of transfer, the court's focus is exclusively on the actual intent of the debtor. The second type is commonly referred to as a constructive fraudulent transfer. In the constructive fraudulent transfer scenario, the debtor's intent is irrelevant. Rather, the focus is on whether the debtor received less than a reasonably equivalent value in exchange for the transfer and whether the debtor was insolvent or left in a precarious financial condition as defined by the Bankruptcy Code. The fraudulent transfer is an infringement of the creditor's right to realize upon the available assets of its debtor. The law imposes a substantive prohibition: the debtor may not dispose of its property with the intent, actual or implied by law, of placing the property beyond the reach of its creditors.

To make out a successful Section 548(a)(1) actual fraud claim, the trustee must prove (1) a transfer to the defendant of (2) an interest in property of the debtor (3) during the year preceding the filing of the petition in bankruptcy (4) accomplished with the actual intent of the debtor to hinder, delay, or defraud a creditor. Furthermore, the first category of transfers and obligations declared by the UFTA to be fraudulent is one made or incurred with actual "intent to hinder, delay, or defraud" any creditor of the debtor. The language in the two acts appeared in the Statute of Elizabeth and has been the core of fraudulent transfer law.

Fraudulent intent is rarely susceptible to direct proof. Nevertheless, intent may be established by circumstantial evidence, or by inferences drawn from a course of conduct. Furthermore, the court may infer fraudulent intent from the circumstances of the case.

Consistent with the fact that a debtor rarely will testify establishing his actual intent to defraud, the courts have historically developed "badges of fraud" as a means circumstantially to prove the actual fraudulent intent. Time and experience have consistently proven the reliability of these ageless indicia of fraud.

While fraudulent acts are as varied as the fish in the sea, there has emerged from this body of case law a number of factors to which courts have attached weight in assessing fraudulent transfer liability. These factors include the relationship between the parties to the transaction, the disparity in value of the assets transferred and value given, the secrecy of the transaction, the timing of the transaction, the existence of a legitimate business purpose for the transaction, a general transfer without a reservation of necessities, the debtor's retained use of the property transferred, a transfer outside the ordinary course of business, unusual clauses in the

1 11 U.S.C. §101 et seq. Bankruptcy Code jurisdiction is found at 28 USC §1334.

2 *Fisher v. Apostolov, 155 F.3d 876, 883 (7*th Cir. 1998).

3 11 U.S.C. §548(a).

business instrument, and the insolvency status of the debtor at the time of the transaction. Of course, the more badges of fraud present, the greater the likelihood of a court finding actual fraud. However, a single badge of fraud may stamp a transaction as fraudulent.

Because the required intent (to "hinder, delay, or defraud") is stated in the disjunctive, it is not a defense that the debtor intended merely to delay or to hinder seizure of his property. "Hinder" and "delay" have separate significance for fraudulent transfer purposes. That the debtor believed that his actions were necessary to allow fortunes to improve is no defense to an action under the actual fraud theory. Moreover, it is the debtor's intent that is relevant under Section 548(a)(1)(a), unless the transferee controls the debtor. Finally, the intent to defraud must have existed at the time of the transfer.

Once the estate is shown to be a Ponzi scheme, the trustee begins untangling the spaghetti of the operator's personal finances and any business entities associated with the estate. This process is often extremely complicated, as it is counterintuitive to keep transparent and accurate records for a Ponzi scheme. The trustee then identifies creditors and debtors, and begins the process of litigating all of the estate's claims against debtors. Included in this litigation are debts owed to the estate that are the result of fraudulent transfers (which include returns paid by the estate).

As "a Ponzi scheme is insolvent from inception and becomes increasingly insolvent as the scheme progresses," [4] actual intent is presumed. In fact, courts have ruled that "one can infer an intent to defraud future undertakers from the mere fact that a debtor was running a Ponzi scheme. Indeed, no other reasonable inference is possible."[5] Thus, bankruptcy trustees often seek to depict financial fraud as a Ponzi scheme. Doing so relaxes the difficult standards of proving an actual intent to hinder, delay, or defraud creditors through the common sense presumption.

To make out a successful §548(a)(1)(B) constructive fraud claim, the trustee must prove (1) a transfer to the defendant of (2) an interest in property of the debtor[6] (3) during the two year preceding the filing of the petition in bankruptcy (4) without reasonably equivalent value in exchange for such transfer (5) while the debtor was insolvent or left in some other statutorily-defined precarious financial condition. I will focus on reasonably equivalent value and insolvency.

Reasonably equivalent value as commonly understood generally suggests a comparison of the value transferred by the debtor with the value actually received by the debtor.[7] The bargaining position of the parties, their relationship, the adequacy of the price, the prevailing market conditions, and the marketability of the property transferred are all relevant considerations.[8] Beyond this simple formulation, unfortunately, the case law on reasonably equivalent value is confused. Each court seems to address the issue in a subjective manner. For example, one court, resigned to the fact that no true market comparison could be made to determine reasonably equivalent value because no such market existed, nevertheless created a hypothetical market to gauge the price paid by the transferee.[9]

Based on a careful distillation of the cases, it does appear that a model of reasonably equivalent value may be constructed. The model is a functional one, a process-sensitive approach to assessments of value. The approach suggests that if the process actually employed by the parties to reach a value is reasonable, then the fruit of that process is itself reasonable. Thus, the purchase price of an asset transferred wherein the price was reached by arm's length negotiations will generally approximate reasonably equivalent value. The focus then shifts to process and not price, although price is still a valid and, in the appropriate circumstance, important consideration.

In Ponzi schemes, there is no arm's length transaction. The fraudster is making a promise that by definition he cannot keep. The process is deceptive, unlawful, and preys on trust. The fruits of that process are tainted.

Under fraudulent transfer law, a lack of reasonably equivalent value is necessary but not sufficient before a court condemns a transfer made or obligation incurred as constructively fraudulent. In addition to lack of a reasonably equivalent value, the transfer made or obligation incurred must occur when the debtor is (1) insolvent or rendered insolvent, (2) left with unreasonably small capital, or (3) left with an inability to pay its debts as they became due.

Although a thorough discussion of the solvency question is beyond the scope of this outline,[10] several additional observations should be made. First, insolvency is a legal term of art. Accounting or finance principles inform the inquiry; they do not constrain it. Thus, the definition of asset or liability, for example, is not a Generally Accepted

4 *In re: Rodriguez, 209 B.R. 424, 432 (Bankr. S.D. Texas 1997).*

5 *In re Independent Clearing House Company, 77 B.R. 843, 860 (Bankr. D. Utah 1987).*

6 The Bankruptcy Code does not define the phrase "interest of the debtor in property." Although the question of what constitutes an interest of the debtor in property is a question of federal law, the courts will consult state law in determining whether this element is met. 1A BANKR. SERV. L. ED. §§5D:12, at 19 & n.1 (cases cited therein). The property requirement enjoys a broad scope and is generally construed in light of the purposes of fraudulent transfer law. Generally, the transfer must have depleted the debtor's estate. *Id. §5D:12, at 19-20 & n.2 (cases cited therein). (*Emphasis added).

7 See 1A BANKR. SERV. L. ED. §5D:45, at 42 (1990).

8 See also *Jacoway v. Anderson (In re Ozark Restaurant Equip. Co.)*, 850 F.2d 342 (8th Cir. 1988) (analysis of reasonably equivalent value in fraudulent transfer context requires consideration of "the entire situation" including market conditions).

9 See *Cooper v. Ashley Communications, Inc. (In re Morris Communications NC, Inc.), 75 B.R. 619, 622-25 (Bankr. W.D.N.C. 1987),* rev'd, 914 F.2d 458 (4th Cir. 1990).

10 For a thorough discussion of solvency, including proof issues, see Frank R. Kennedy, Vern Countryman, and Jack F. Williams, Kennedy, Countryman, & Williams on Partnerships, Limited Liability Entities, and S Corporations in Bankruptcy, Chapter 6 (2000).

Ponzi Schemes *continues from p. 5*

Accounting Principal ("GAAP") question; it is a legal one. Second, in this context, the question is one of bankruptcy law. Finally, the test for insolvency for fraudulent transfers is the same test used to determine insolvency for preference action with one notable exception. In a fraudulent transfer analysis, you must assess insolvency immediately before and after the transfer made; section 548(a)(1)(A)[11] ensnares transfers made by the debtor while insolvent *or that render a debtor insolvent*. However, under §547(b)(3),[12] a preference is avoidable when a debtor makes the transfer while insolvent.

Often, proving insolvency in a Ponzi scheme is a relatively straightforward matter. As several courts have noted, Ponzi schemes generally should be deemed insolvent from the outset.[13] In a traditional Ponzi scheme, there is no legitimate source of funds and the liabilities are increasing with each new investor. Thus, insolvency is the only reasonable inference.

In cases where a scheme began as a legitimate business but degenerated into a Ponzi scheme, the question of solvency is more difficult. The Code requires solvency to be assessed as of the transfer date, and thus there will often be a question as to whether the Ponzi scheme was in operation as of the transfer date. In these cases, a trustee should employ a CIRA or other forensic expert to prove insolvency through both traditional and nonconventional methods.

A trustee's causes of action against third parties in a Ponzi scheme can be very messy. Any business entity that had been involved with the scheme or with the scheme operator is subject to scrutiny, including professionals such as accountants, lawyers, and investment advisors. An entity that enabled the operator of a Ponzi scheme is an especially likely target. Even if the entity was unaware of the Ponzi scheme, to defend against claims it must prove that it acted in good faith.[14] Attorneys, accountants, banks, and even certain investors may also be the target of claims. These claims can range from professional negligence to outright fraud, as well as aiding and abetting a fraud.[15]

In distributing assets of the estate, few, if any, end up as winners. In a "rising tide" method, what an investor received prior to collapse of the scheme is debited against the payment he/she would receive from the estate. The payments/returns are treated as a payment from the estate and investors who received such payments may receive nothing from the estate. There is a growing concern this method does not square with the Bankruptcy Code.

The "net loss" or "net investment" method combines all of the investors into one group and subtracts all payments/returns. That is, it estimates loss as net loss to the group, rather than on an individual basis. This method may also fail to square with the Bankruptcy Code.

The "net equity" method generally follows the Bankruptcy Code.[16] Under the net equity method, all payments/returns are considered fraudulent transfers. Investors who received more than they invested are likely to have funds clawed back.[17] Additionally, investors who received a return of their basis in the investment may also find themselves the subject of a clawback action. Because all payments/returns are fraudulent transfers, SIPC is generally not available for the amount beyond an investor's initial investment.[18]

My next column will discuss the defenses to a fraudulent transfer action in the Ponzi scheme scenario and share the red flags and protective steps one should take to avoid being a Ponzi victim. ■

Upcoming Courses

CDBV

Malibu, CA
Part 1: January 19-21, 2011

Malibu, CA
Part 2: February 1-4, 2011

Orlando, FL
Part 1: February 28-2, 2011

Register Online at
www.AIRA.org

11 11 U.S.C. §548(a)(1)(A).

12 11 U.S.C. §547(b)(3).

13 *Merrill v. Abbott (In re Indep. Clearing House Co.) 77 B.R. 843, 871 (C.D. Utah 1987); Martino v. Edison Worldwide Capital (In re Randy) 189 B.R. 425, 441 (N.D. Ill. 1995).*

14 *In re Agricultural Research and Technology Group, Inc., 916 F.2d 528, 535 (*9th Cir. 1990).

15 See, 27 Cal. App. 4th 832 ("Liability may also be imposed on one who aids and abets the commission of an intentional tort if the person (a) knows the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other to so act or (b) gives substantial assistance to the other in accomplishing a tortuous result and the person's own conduct, separately considered, constitutes a breach of duty to the third person").

16 15 USC 78lll. "Definitions": "(11) Net equity… means the dollar amount of the account or accounts of a customer, to be determined by – (A) calculating the sum which would have been owed by the debtor to such customer if the debtor had liquidated… minus (B) any indebtedness of such customer to the debtor... plus (C) any payment by such customer of such indebtedness to the debtor which is made with the approval of the trustee."

15 USC 78fff(b) "Application of title 11": "To the extent consistent with the provisions of this chapter, a liquidation proceeding shall be conducted in accordance with, and as though it were being conducted under chapters 1, 3, and 5 and subchapters I and II of chapter 7 of title 11."

17 The Bankruptcy Code allows for a claw back of fraudulent transfers in the two years preceding the initiation of proceedings, although most states allow claw backs for the period 4-6 years preceding the bankruptcy.

18 *In re New Times Securities, 371 F.3d 68, 88* ("We adopt the view that the Claimants' net equity is properly calculated as the amount of money that the Claimants initially placed with the Debtors to purchase the New Age Funds and does not include the artificial interest or dividend reinvestments reflected in the fictitious account statements the Claimants received from the Debtors."); *In re Adler, Coleman Clearing 247 B.R. 51, 105* ("The Challenged Trades are the result of Honver's massive fraud, not ordinary course transfers, and the statute simply does not insulate transactions like these from attack under § 548(a)(1)(B) of the Bankruptcy Code.").

Making Sense of the Current Restructuring Market

Alan D. Holtz, CIRA
AlixPartners

Spencer Ware, CIRA
AlixPartners

With unemployment hovering around 10%, the stock market at 2005 levels, the trade deficit trending upwards and the massive bankruptcies of 2009, one could reasonably expect corporate restructuring activity to be at very high levels in 2010. Yet most restructuring professionals would tell you that this seemingly intuitive conclusion is simply not accurate. Actually, many of these professionals are finding that 2010 has evidenced a dramatic slowdown in restructuring activity. Why is it that in the midst of potentially the most difficult economic era since the Great Depression there is not more work for bankruptcy attorneys, turnaround consultants and restructuring bankers? Let us try to explain.

Is there really less work for restructuring professionals?

First, it is important to substantiate that there has truly been a reduced level of restructuring activity during the past twelve months. One way of evaluating this is by looking at the high-yield default rate, which is often seen as a measure of the level of corporate distress. After sitting below 3% between 2004 and 2008, defaults spiked up to around 14% in 2009. Recently, however, the rate is back down to under 4%. This alone would suggest a much lower level of restructuring activity in 2010 than in 2009.

Corporate Chapter 11 activity is another way to gauge the general level of restructuring work. For the first three quarters of 2010 there were 43,016 corporate Chapter 11 filings in the U.S. This is down approximately 5.5%, from 45,510 filings during the comparable period in 2009. Though this statistic would support a minor slowdown in restructuring activity, it does not tell the whole story. Peeling back the onion, we find that the average size of the largest Chapter 11 cases is getting much smaller.

The top 20 cases filed in 2010[1] were on average 94% smaller than those in 2009, and the third largest filing in 2010 would not have even made the top 20 list in 2009 (see Exhibit 1). These comparisons show there has been a dramatic shift from larger to smaller companies filing during 2010. With smaller companies filing for Chapter 11, we see less restructuring work and fewer cases that require or can support assistance from national or regional law firms, investment bankers and financial advisors.[2]

1 Excluding financial companies, the nature of whose balance sheets could distort the analysis.

2 The authors focus on the experience of mid-size and larger firms in this article. With the smaller size of filings in 2010, it may be possible that work has increased for practitioners focusing on smaller companies.

Exhibit 1

Top 20 Chapter 11 Bankruptcies By Year

2010 YTD				2009			
#	Company	Filing Date	Liabilities	#	Company	Filing Date	Liabilities
1	Truvo USA LLC	July 1, 2010	$ 3,574	1	General Motors Corp.	June 1, 2009	$ 172,810
2	Metro-Goldwyn-Mayer Studios Inc.	November 3, 2010	3,451	2	Chrysler LLC	April 30, 2009	55,200
3	Innkeepers USA Trust	July 19, 2010	1,519	3	General Growth Properties Inc.	April 16, 2009	27,294
4	Blockbuster Inc.	September 23, 2010	1,465	4	Charter Communications Inc.	March 27, 2009	24,186
5	Saint Vincent Hospital	April 14, 2010	1,092	5	Lyondell Chemical Co.	January 6, 2009	19,337
6	Almatis BV	April 30, 2010	1,038	6	R.H. Donnelley Corp.	May 28, 2009	12,374
7	TerreStar Networks Inc.	October 19, 2010	1,000	7	Idearc Inc.	March 31, 2009	9,515
8	Boston Generating LLC	August 18, 2010	1,000	8	AbitibiBowater Inc.	April 16, 2009	8,783
9	Penton Business Media Holdings	February 10, 2010	1,000	9	Extended Stay Inc.	June 15, 2009	7,674
10	nCoat Inc.	August 16, 2010	914	10	Station Casinos Inc.	July 28, 2009	6,483
11	Mesa Air Group Inc.	January 5, 2010	869	11	Smurfit-Stone Container Corp.	January 26, 2009	5,582
12	Xerium Technologies Inc.	March 30, 2010	813	12	Visteon Corp.	May 28, 2009	5,324
13	Natural Products Group LLC	January 27, 2010	804	13	Lear Corp.	July 7, 2009	4,540
14	Oriental Trading Co.	August 25, 2010	757	14	Spectrum Brands Inc.	February 3, 2009	4,446
15	Centaur LLC	March 6, 2010	681	15	Aleris International Inc.	February 12, 2009	3,980
16	Atrium Corp.	January 20, 2010	665	16	Reader's Digest Association Inc.	August 24, 2009	3,400
17	Neff Corp.	May 16, 2010	609	17	FairPoint Communications Inc.	October 26, 2009	3,234
18	DB Capital Holdings LLC	May 27, 2010	560	18	Nortel Networks Inc.	January 14, 2009	3,200
19	South Bay Expressway LP	March 22, 2010	550	19	Erickson Retirement Communities LLC	October 19, 2009	3,000
20	American Safety Razor Co. LLC	July 28, 2010	531	20	Premier International Holdings Inc.	June 13, 2009	2,907
	Total		**$ 22,893**		**Total**		**$ 383,269**
	Average		**$ 1,145**		**Average**		**$ 19,163**

Restructuring Market *continues from p. 7*

In addition to size, the duration of the bankruptcy cases filed affects the amount of work for advisors in the restructuring arena. Looking at Chapter 11 cases since 1980, we see a steady decline in the average case duration across all types of corporate Chapter 11 cases (see Exhibit 2).

A full explanation for the shortening of case length is not critical for the discussion of the current restructuring market, but we offer two reasons for the change over the past several years. The first is the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, which capped a debtor's exclusivity period at 18 months. The second reason (which may, in fact, be partially a result of the first reason) is that prepackaged and prenegotiated bankruptcies have increased in popularity (see Exhibit 3).

Exhibit 4

Program	Invested	Committed	Description
Federal Reserve Rescue Efforts	~$1,500	$4,000	Fannie Mae & Freddie Mac debt purchases ($200) & MBS purchases ($1,250), US Government bond purchases (before 11/01/10. $300 and after 11/01/10 $600), TALF ($1,000)
Federal Stimulus Programs	~$770	$1,200	Economic stimulus act of 2008 ($168), American Recovery & Reinvestment Act ($787), student loan guarantees ($195), 'Cash for Clunkers' ($3)
Troubled Asset Relief Program (TARP)	~$390	$700	Financing assets associated with AIG ($70), auto industry ($80), bank bailouts ($220), Public-Private Investment Program ($100)
Other Financial Initiatives	~$365	$1,700	Temporary Liquidity Guarantee Program ($1,500), costs to NCUA (backed by the US Government) for bailout of credit unions ($58)
Other Housing Initiatives	~$130	$745	Fannie Mae & Freddie Mac bailouts ($400), FHA Housing Rescue including first-time home buyer credit ($320)
American International Group (excl. TARP)	~$80	$112	CDO & MBS purchases ($52), bridge loan ($44), etc.
FDIC Failed Bank Takeovers	~$45	$45	Cost to fund depositor losses
Total	**~$3,300**	**~$8,500**	

Source: CNN
Note: Figures in brackets represent committed funds

So, the default rate is down significantly, and while the number of Chapter 11 filings is down only 5.5% from 2009 to 2010, the reduced size and shorter duration of the cases are clearly driving a far greater reduction in the level of work for the professionals.

Why hasn't the current economy generated more large bankruptcies?

Next it is necessary to explain why, in the midst of these difficult economic times, there are not more large bankruptcy cases being filed. It is our view that a combination of different government policies and actions and capital market factors has brought us to this point.

Perhaps most significant is that Federal stimulus programs over the last 24 months have injected $3.6 Trillion dollars into the economy, with commitments of an additional $4.7 Trillion (see Exhibit 4). From buying mortgages and stimulating consumer spending - to bailing out banks and auto companies - the federal stimulus programs have injected capital with the objective of preventing an economic collapse. This unnatural inflow of capital has buoyed the economy and staved off an economic contraction and certainly contributed to the slowdown in restructuring activity.

And while federal stimulus programs may have helped avoid further slippage, the economy is not yet growing significantly. The major macroeconomic factor highlighting this is the unemployment rate, which has been hovering around 10% for the last six quarters. Although GDP has been slightly positive since the middle of 2009, this growth has been offset by an increased savings rate, which has acted to siphon off reinvestment and mute the impact of the limited growth. Taken together, these three data points suggest that corporations are not investing back into the economy, leaving it in a stagnant state.

Placing this period of stagnation in the context of expansion and contraction also helps explain why the current economy is producing lower levels of restructuring activity in 2010. The years between the dotcom bust and the collapse of Lehman Brothers were generally characterized by expansion, with

Exhibit 2

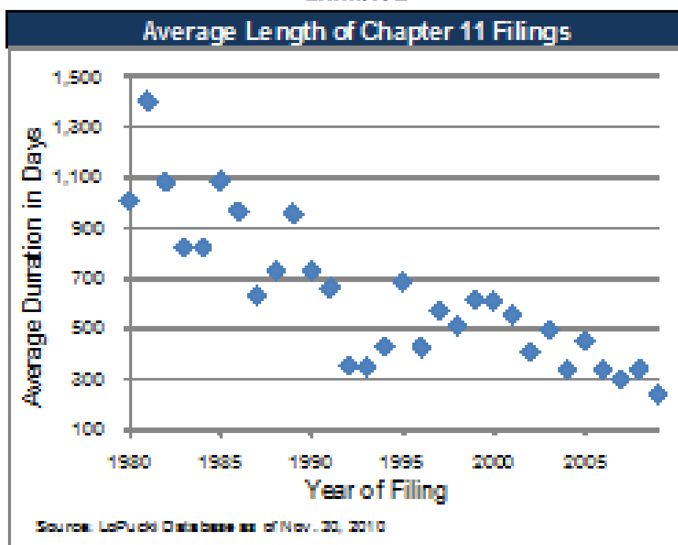


Exhibit 3

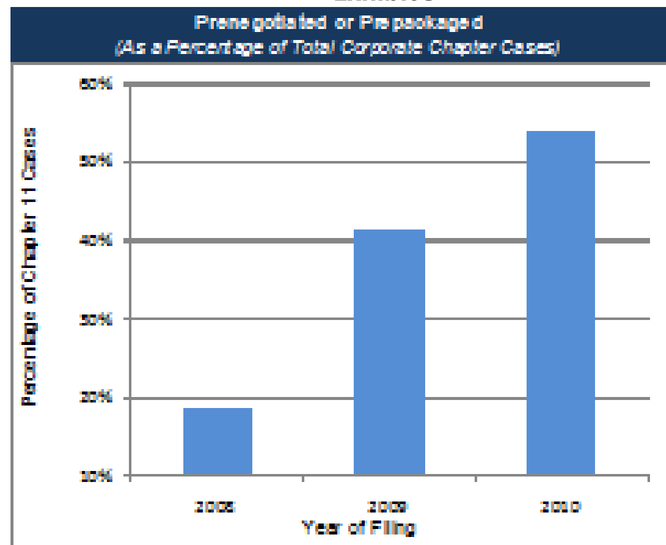


Exhibit 5

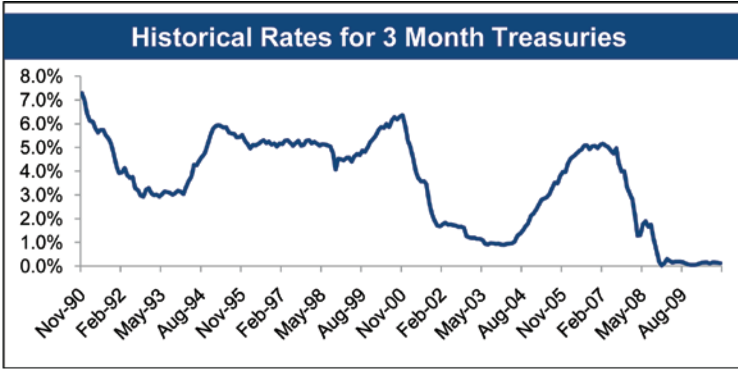
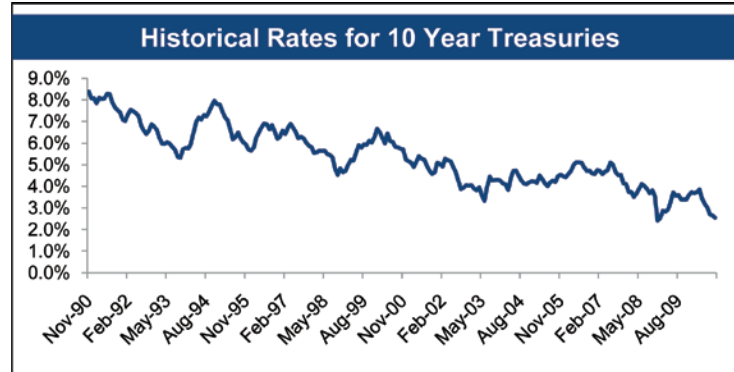


Exhibit 6



Source U.S. Department of Treasury Data as of Nov 3, 2010

GDP averaging 5.5% between 2005 and 2007, while mid 2008 and 2009 moved sharply in the opposite direction. Contraction of the economy contributes to restructuring activity as solutions must be found for overleveraged players. And in our opinion, restructuring activity is also prompted by economic expansion, because when credit markets are loose, some capital will inevitably be misapplied, and "the weak get weaker." However, in a stagnant economy like we are experiencing today, not much of anything happens, and this includes restructurings – yet another reason for the lower level of activity in 2010.

Historically low interest rates have also contributed to the recent slowdown of restructuring activity (see Exhibits 5 and 6). Lower rates reduce the interest burden and thus improve cash flows for companies with floating rate debt. Further, better cash flow resulting from lower interest payments can improve covenant calculations. So companies skating near the edge may be squeaking by with respect to both liquidity and covenant compliance as a result of the current low interest rate environment.

Another way that low interest rates have kept companies from restructuring is that lenders may be discouraged from working out their troubled credits knowing that they would need to redeploy capital at lower rates. Instead, many lenders are using the "amend and extend" strategy to defer the workout of overleveraged credits.[3]

Low interest rates have also made capital more accessible to potential restructuring candidates, a byproduct of which is the resurgence of the high-yield market. High-yield issuances are at greater levels by far than they have been in recent history, totaling $467 Billion for the 11 months ending November 30, 2010. This is 2.5 times larger than the average issuances from 2000 to 2009 at $125 Billion (see Exhibit 7). The resurgence of this area of the credit markets has facilitated the refinancing of looming maturities for many overleveraged companies, as evidenced by the shift in maturities of leveraged loans and high-yield maturities (see Exhibit 8).

Without the comeback of the high-yield market, some of these overleveraged companies might have otherwise been

Exhibit 7

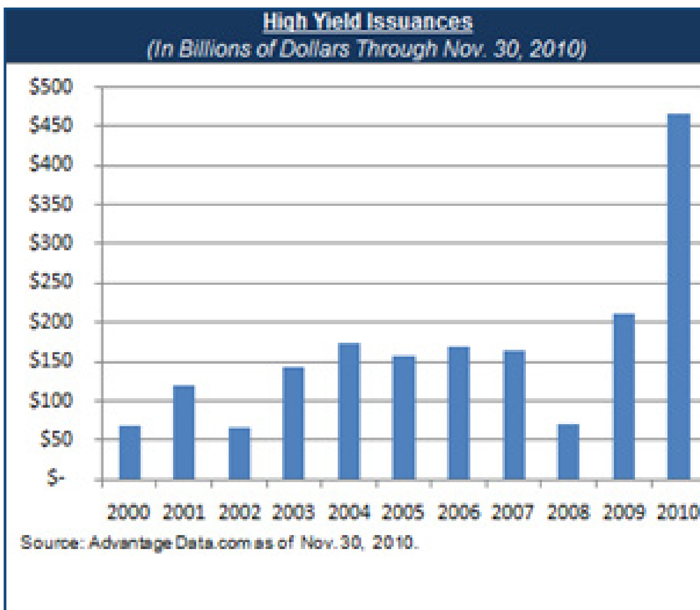
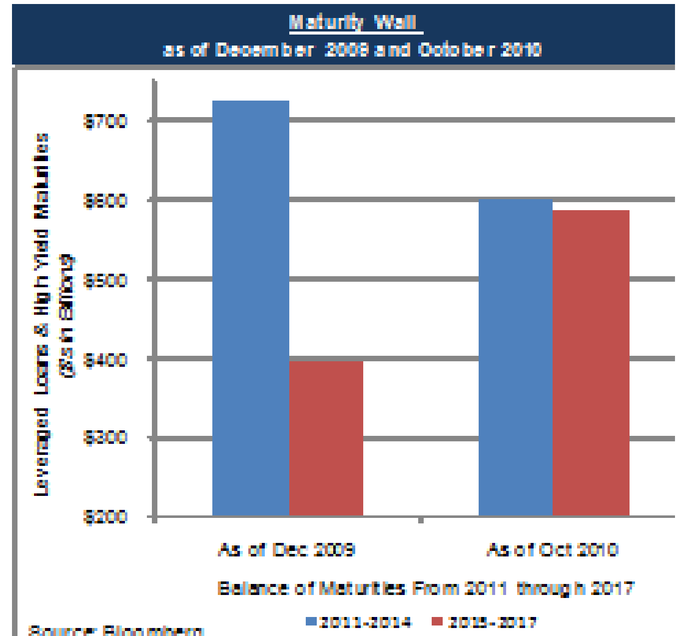


Exhibit 8



3 Other factors such as regulatory capital requirements and the condition of banks' own balance sheets may also be encouraging lenders to defer recognition of losses and avoid borrower restructurings in the current environment.

Restructuring Market *continues from p. 9*

forced to face a comprehensive debt restructuring. "The credit markets of 2008 and 2009 clearly would not have entertained many of the highly leveraged refinancings we have seen in 2010, which reflect an enormous thirst for yield by investors globally," asserts Stephen Goldstein, a managing director at Lazard. Gray Television, MGM Resorts, and the Ryland Group are examples of potential restructuring candidates that were uniquely able to amend and extend their facilities because of this credit cycle. Grey Television issued $365 Million of second lien notes rated Caa2 by Moody's, MGM Resorts issued a cumulative $1.345 Billion of debt rated CCC+ by Standard and Poor's and the Ryland Group issued $300 Million of bonds rated BB- by Standard and Poor's.

The high-yield markets also help explain why Chapter 11 cases are 90% smaller in 2010 than those in 2009. "Smaller borrowers simply do not have access to the high-yield market," points out Deirdre Martini, a managing director at Wells Fargo Capital Finance. "With more limited refinancing options available to them in the current environment, smaller companies are more likely to require a formal restructuring than larger companies."

When will we see a resurgence of restructuring activity?

All of these drivers – case size, case length, federal stimulus programs, the stagnant economy, low interest rates and a very active high-yield market – help to explain why there is less restructuring work during this time when many might expect to see record levels of such activity. The clear follow up question is: "Will restructuring activity pick up, and when?"

"Ultimately, a lot of the overall fundamental problems within the system at all levels (i.e., sovereign, state and municipal debt, as well as corporate and consumer leverage) have not been fixed, and it's likely only a matter of time until there is a dramatic repricing of risk to the detriment of weaker credits," notes Lazard's Goldstein.

Below are four possible paths for the economy, each of which would have a different impact on the level of restructuring activity:

1. If the economy is headed toward stagflation, as some experts suggest, restructuring candidates may be able to able to limp along and continue refinancing as capital remains cheap.
2. If there continues to be small real GDP growth but reinvestment returns, more restructuring activity could result from a shakeout of weaker companies as their competition become stronger.
3. If the federal government stops propping up the economy with stimulus programs and low interest rates, we may begin to see a more natural level of distress.
4. If there is an unforeseen political, environmental or technological event, this could either push us into another recession or jump start an economic rebound, driving, in either case, more restructuring activity.

Time will tell which route the economy will take and when the restructuring market will become more active. However, with a better appreciation for some of the factors that drive this work, several of which are counter-intuitive, restructuring professionals will be better prepared to adapt to whatever lies ahead. ■

Alan Holtz is a Managing Director at AlixPartners, based in New York. He has almost 23 years of experience providing advice on all aspects of financial restructuring to company management and boards, financial institutions and creditors' committees, across a wide variety of industries.

Spencer Ware is an Associate at AlixPartners, based in New York. He has expertise including bankruptcy preparation and management, liquidity analysis and business planning and has provided services to a diverse range of clients over the past eight years.

SAVE THE DATE – Upcoming AIRA Events

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27th Annual Bankruptcy & Restructuring Conference
June 4-7, 2011 | InterContinental Boston | Boston, MA

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Bankruptcy Valuation

Kenji Mochizuki
Livingston Securities LLC

INAUGURAL ARTICLE

INTRODUCTION AND GUIDELINE COMPANY TRANSACTION MULTIPLE APPROACH (PART 1)

In the first year and a half of this Great Recession, roughly 60% of global market capitalization was erased. With no fundamental economic improvements and fears of a global depression or U.S. double dip recession, business valuation in bankruptcy became less precise and more complex. Concomitantly, there was a subsequent increase in bankruptcy litigation where the value of the business enterprise was at issue.

In this climate, the AIRA Journal launches its new finance section. Both the AIRA Journal and its predecessor, the AIRA News, contained accounting (Taxes) and legal (Cases) sections. With this inaugural article, this finance (Valuation) section will explore valuation issues and finance topics in bankruptcy from the investment banker's viewpoint. Future articles will also include the insights of other financial advisors, valuation consultants, judges, etc..

Our first topic will be the guideline company transactions approach, because it is sometimes underutilized, misused, and misinterpreted. We will focus on: 1) the end point in Wall Street valuation often being a valuation football field chart; 2) screening for "good" guideline companies by closer inspection of various criteria (discussed in my next article); and 3) screening for "good" guideline transactions by examination of the deal dynamics.

Current Resources

For those interested in learning more about valuation and finance issues, the AIRA already offers several resources. Past webinars are now available as AIRA Self Study Courses, two of which are entitled, "Business Valuation & Bankruptcy" and "Recent Developments in Valuation". Valuation and finance are included in the curriculum for both the Certified Insolvency and Restructuring Advisor (CIRA) and the Certification in Distressed Business Valuation (CDBV) examinations.

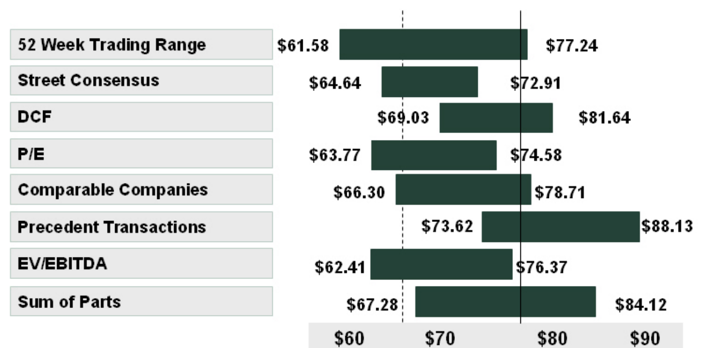
The AIRA Journal represents a valuable archive, including the recent survey article entitled, "Current Valuation and Solvency Issues in Practice" in the Volume 22, Number 4, October/November 2008 issue. In addition to the annual Conferences and VALCON events, most AIRA meetings and events include panels that discuss valuation and finance issues.

The Goal: Valuation Football Field

On Wall Street, the final deliverable is typically a pitch book with a valuation football field chart that shows a range of price estimations for a variety of valuation methodologies. Just as a larger sample size is necessary to get a statistically significant result, the utilization of additional methodologies may lead to a more accurate business valuation. While some valuation methodologies can become inapplicable due to the company's lack of positive earnings, inconsistent cash flows, etc., guideline transactions can often find a place in the business valuation. Some firms include guideline transactions for all valuation projects.

The illustration below for a fictional publicly traded company is greatly exaggerated to show the utilization of many valuation methods. The right axis permits a range of values, instead of just a single definitive valuation number. Solid and/or dotted lines denote the implied valuation range, which is based upon the median value of each methodology's range. The median is the middle value in a list of numbers, separating the higher half of a sample from the lower half.

The left axis lists the various valuation methodologies used. For publicly traded companies, the 52 week high and low as well as current stock price can be included as a representation of how the public markets valued the company. The consensus of Wall Street equity research analysts is a useful point of reference. Trading comps (or comparables), also known as public comps or comparable companies, can include both Wall Street equity research analyst estimates and the more optimistic management projections. Deal comps, also known as precedent transactions or guideline transactions, is discussed below. For bankruptcy and distressed company valuations, several of the other valuation methodologies might be less relevant, and additional methodologies such as liquidation values would be included.



Definition: Guideline Transactions Approach

The Statement on Standards for Valuation Services No. 1 (SSVS No. 1) issued in June 2007 by the American Institute of Certified Public Accountants (AICPA) defines the guideline company transactions method as one within the market approach whereby market multiples are derived from the sales of entire companies engaged in the same or similar lines of business. It is also referred to as deal comps, precedent transaction analysis, merger and acquisition (M&A) method, or comparable M&A transactions. The transactions method uses those multiples of the target

companies as a guideline for the estimate of reasonable multiples for the subject company.

Guideline transactions typically results in higher business valuations due to potential synergies for the acquirer as well as a control premium. Because the previous issue of the AIRA Journal contained a feature article on control premiums, it will not be discussed here except to make note whether this control value is only of the value of the equity or of all the invested capital.

Wall Street often uses precedent transactions in corporate finance as well as mergers and acquisitions (M&A), but rarely in equity research. At my firm, we recently analyzed approximately 100 initiating coverage equity research reports published by around 50 different U.S. investment banks. Precedent transactions were used only twice, in both instances to supplement other valuation methodologies for stocks that were difficult to value. One reason for the lack of popularity is the equity research analysts' perception that it is a backward looking, instead of forward looking, valuation method.

Screening Good Guideline Transactions: Deal Dynamics

Screening good guideline companies will be discussed in my next article. Having found comps as similar to the subject company as possible, we are now prepared to generate a comparable universe of transactions. One approach is by examining the particular circumstances surrounding the transaction that could have impacted the price paid by the acquirer. A solid discussion can be found in *Investment Banking: Valuation, Leveraged Buyouts, and Mergers & Acquisitions,* by Joshua Rosenbaum and Joshua Pearl (Wiley, 2009). While various discounts and adjustments can be made to the guideline transaction data (discussed in my next article), typically these insights are utilized only to refine the screening and selection process of the universe of comparable transactions.

Cash vs. stock: An all-stock transaction results in a lower valuation because when the shareholders of the target company receive stock, they can share in any potential upside from future growth and realized synergies. Additionally, if the company is sold in the future, target shareholders could obtain a control premium. On the other hand, an all-cash transaction results in a higher valuation because shareholders of the target company require higher upfront compensation by the acquiring company. The loss of equity interest in the combined entity prevents any participation in potential value creation opportunities in the combined entity.

Strategic buyer vs. financial sponsor: Historically, strategic buyers such as competing companies could pay higher purchase prices because of their potential ability to realize synergies from the combined entity. When the public markets were willing to supply inexpensive debt with favorable terms in the mid-2000s, financial sponsors such as private equity investment funds were able to compete with strategic buyers on the purchase price. Since debt financing became expensive and scarce in the second half of 2007, the advantage shifted back to strategic buyers because only the strongest and most creditworthy companies were able to source acquisition financing.

Sale process: A hostile takeover bid involves a proposed acquisition despite the expressed opposition of the Board of Directors of the target company. Typically the publicly traded company being purchased doesn't want to be purchased (by the particular buyer that is making a bid). Alternatives and defenses to hostile takeovers often lead to higher transaction prices. When the sale process is an auction, the target company is shopped around to numerous prospective acquirers. The resultant competitive dynamics ideally produces the best offer at the highest possible price.

Nature of the deal: In many transactions, one company actually acquires another company. There is an acquirer who is the purchaser and typically larger in size, and a target company that is for sale and typically smaller in size. However, in a merger of equals, neither firm acquires the other. Often, the two firms are of similar size. Both sides may forego a premium since they participate equally in the upside. Shareholders from both firms surrender their shares, and receive new securities issued by the new single company.

Motivations: Seller motivations can influence purchase price, esp. when in urgent need of cash. Instead of a value maximization strategy, the seller may accept a lower valuation in exchange for speed of execution and certainty of completion. Buyer motivations can also influence the purchase price. A strategic buyer may pay a higher price if the target company's assets are critical to its strategic plan. A financial sponsor may pay a higher price when pursuing a roll-up acquisition strategy, where synergies might be realized by combining the target company with existing portfolio companies. By acquiring and merging the multiple smaller companies, the financial sponsor attempts to establish the dominant company in the marketplace and to build the leading brand in that market.

Take Home Messages

- Even in the current economy, the guideline company transaction method can be useful.
- Just as a larger sample size is necessary for statistical significance, the utilization of additional valuation methods may lead to a more accurate business valuation. The various results can then be portrayed in a valuation football field chart.
- Don't just look at purchase prices and market capitalizations when finalizing the universe of comparable acquisitions, but also consider the dynamics of the deal. The highest valuation is seen in an all-cash transaction with strategic buyers through an auction process or hostile takeover situation. ■

Kenji Mochizuki, Section Editor, is a General Securities Principal whose registrations include Series 7, 24, and 66 at Livingston Securities, LLC, a boutique investment banking and advisory group specializing in emerging technologies such as cleantech, energy, healthcare, and nanotechnology. He previously worked in the venture capital and hedge fund industries. Kenji Mochizuki may be contacted at 1(212)520-8468 or kenji@livingstonsecurities.com

Rights Offerings continues from p. 1

purchase more than their pro-rata share if unsubscribed securities are available, while overallotment rights permit holders to purchase additional securities even when the offering is fully subscribed. The use of oversubscription/overallotment rights in connection with backstop rights provides debtors with substantial flexibility in the offering process, facilitating the debtor's ability to achieve the optimal capital and ownership structure upon emergence from bankruptcy.

Securities Law Exemption

Another benefit to rights offerings in bankruptcy is the potential to exempt the new securities from registration with the Securities and Exchange Commission ("SEC"). Registration is typically lengthy and expensive, but Bankruptcy Code section 1145 permits a debtor to issue securities in the reorganized company without registration if certain conditions are met. To rely on the securities law exemption under section 1145(a)(1), the new offering of securities must be issued (1) under a plan of reorganization; (2) by the debtor, an affiliate of the debtor or a successor to the debtor; and (3) in exchange for claims against or interests in the debtor or "principally" in exchange for such claims or interests and partly for cash or property. Section 1145(a)(2) also provides an exemption for offerings of securities through warrants, options, rights to subscribe or conversion privileges when the original security is issued in compliance with section 1145(a)(1).

To qualify for the exemption when securities are exchanged for cash or property in addition to claims or interests, the debtor-in-possession must be careful to ensure that the transaction does not appear to be primarily an effort to raise fresh capital—in other words, the claims or interests exchanged for the right to participate, not the new money raised, must be the central aspect of the rights offering. Under the statute, the exemption is unavailable if the amount of cash or property given by a claimant transforms the transaction into something other than securities issued "principally in exchange" for the claims or interests, sometimes referred to as the "principally/partly" test. This test raises the question: How much cash or property is too much in a section 1145(a) transaction?

The text of section 1145, "principally in exchange," could be read to simply require that the exchange of property and cash be less than the amount of the surrendered claim or interest. SEC no-action letters, however, have suggested that "principally in exchange" may require a lower ratio of cash to claim or interest value. For instance, in *Bennett Petroleum Corporation*,[1] the SEC agreed that the exemption applied to a plan of reorganization where the debtor exchanged new preferred stock for old common stock plus cash. The exchange was structured to provide a cash amount equal to 75% of the value of the interests being surrendered (e.g., cash of $75 million compared to old stock tendered with a value of $100 million).

Similarly, in *Jet Florida System, Incorporated*,[2] the SEC requested further information regarding a plan under which the unsecured creditors received new common stock and subscription rights, among other things, in exchange for their claims. The SEC agreed not to take enforcement action with respect to the application of the exemption after the debtor established that the value of the claims the creditors exchanged was substantially greater than the $2.40 subscription price. As in *Bennett Petroleum,* the ratio of cash value to the value of claim exchanged for the new securities was approximately 75%. The SEC no-action letters appear to provide a safe harbor at 75% for meeting the principally/partly test; however, a rights offering could have a ratio of more than 75% (e.g., $95 million in cash raised compared to stock surrendered with a value $100 million) and still potentially satisfy the requirements of section 1145.

Section 1145, by its own terms, does not exempt transfers to underwriters. As a result, shares purchased by the backstop party are typically not exempt from registration under section 1145. Thus, to issue new securities to the backstop, the debtor usually relies on a private placement exemption. Additionally, if the backstop seeks to sell its shares to the public at some point in the future, the backstop may separately require the reorganized company to go through the registration process after the offering has been completed.

Use of Rights Offerings in Recent Cases and Related Issues

Among other uses, rights offerings can be an effective tool for junior creditors or equity security holders to bolster their position on valuation by demonstrating a willingness and financial commitment to invest new money premised on a higher valuation—i.e., put their money where their mouth is.

For instance, a proposed rights offering backed by certain equity holders was utilized in the GSI Group, Inc. case to (i) convince the debtors to abandon a plan negotiated with certain noteholders and premised on a lower valuation and (ii) ultimately reach a consensual plan on much more favorable terms for equity holders. In GSI Group Inc., the debtors commenced their chapter 11 cases with a prenegotiated plan supported by the holders of the debtors' $210 million of unsecured notes. The prenegotiated plan contemplated that the noteholders would receive new notes of $95 million and approximately 80% of the equity in the reorganized entity, and existing shareholders would receive approximately 20% of the new equity. Following several weeks of litigation over valuation and the debtors' subsequently proposed modifications to the plan to improve the treatment of equity holders, the equity committee proposed an alternative plan premised on a rights offering with a higher enterprise value than the plan the debtors and noteholders were seeking to cram down. The rights offering under the alternative plan was to be backstopped by one of the shareholders on the committee, and the alternative plan proposed to pay down a substantial portion of the notes in cash and reinstate the balance of the notes. Initially, the parties could not come to an agreement on a consensual plan because a subgroup of noteholders

1 SEC No-action Letter (available Dec. 27, 1983).

2 SEC No-action Letter (available Jan. 12, 1987).

wanted a share of the upside in the reorganized company, as opposed to cash and new notes, and there was a fundamental disagreement over the enterprise value of the reorganized entity and thus the value of the new equity to be distributed under the plan.

Ultimately, the valuation dispute was resolved through the creative use of the backstop right coupled with a potential overallotment right. Under the consensual plan, the noteholders agreed to backstop the offering and the equity committee agreed the noteholders would have the right to purchase a certain minimum amount of the new equity—even if the offering was fully subscribed. Because it was anticipated that a portion of the existing equity holders would elect not to participate in the offering, much of the allotment guaranteed to the backstopping noteholders was expected to come from equity holders that elected not to participate in the offering. Following the completion of the rights offering under the plan, existing equity holders retained approximately 86% of the stock in the reorganized company, and the noteholders received, among other things, the cash proceeds from the rights offering and new secured notes. As anticipated, the guaranteed minimum equity for the noteholders was fulfilled in part from existing equity holders that chose not to participate, reducing the dilution of the participating equity holders who believed the shares were worth substantially more than the subscription/conversion price.

Because participation in a rights offering is often viewed as a valuable right, issues have arisen in recent cases over the ability to participate, including whether similarly situated creditors or shareholders are receiving equal treatment under a plan.

For instance, in *Dana Corp.*, the debtor reached agreements with its unions and with a financial sponsor for exit financing. Under those agreements, the financial sponsor would backstop a rights offering for new preferred stock that would include, among other things, consent rights for certain transactions. To make its corporate governance manageable, Dana needed to limit the ultimate number of new preferred stockholders. In addition, to reach the desired result and provide confidence that the preferred stock offering would not be materially undersubscribed, the financial sponsor negotiated to limit participation in the offering to sophisticated parties, which would provide greater certainty of participation. To effectuate this plan, Dana developed certain objective criteria for claimants eligible for participation, including a requirement that they hold claims aggregating a certain minimum amount. Ineligible creditors and the creditors' committee objected on the basis the participation right was valuable and was being provided on account of the eligible creditors' claims, thereby resulting in unequal treatment of unsecured creditors. Dana contended, among other things, that the creditors purchasing the preferred stock were not receiving that right on account of their claims and that the smaller ineligible creditors were likely to benefit in any event because larger holders were likely to seek to buy smaller claims at a premium if they wanted to participate. The issue was eventually settled through the provision of an additional settlement fund that ineligible creditors would have the right to share in under certain circumstances, and Dana raised new capital through an offering without creating an unworkable governance structure for the reorganized company.

A similar issue regarding ability to participate arose in *Visteon Corp*. In *Visteon*, the debtors proposed a plan that contemplated, among other things, a $950 million rights offering to unsecured noteholders, which was oversubscribed by more than $110 million, and a $300 million direct purchase commitment from certain noteholders. An ad hoc group of shareholders (representing about 20% of the outstanding shares) objected to plan confirmation on the basis that unsecured creditors were receiving more than 100% on their claims based on the value of the equity being distributed, setting up a complex valuation dispute at confirmation. To resolve the objection and avoid the cost and delay of the valuation trial, the debtors proposed to reimburse the ad hoc shareholder group for the professional fees the ad hoc group had incurred. In addition, to further entice the ad hoc group to drop its objection and vote in favor of the plan, the noteholders agreed to permit the shareholders in the ad hoc group to participate to a very limited degree in the direct commitment portion of the rights offering. No other shareholders were given this right to participate. Because the equity class as a whole would not have voted in favor of the plan without the support of the ad hoc group, the settlement avoided cram down and the valuation trial.

The United States Trustee and certain shareholders objected to the plan and settlement on the basis that (i) the settlement amounted to a purchase of the ad hoc group's votes and (ii) the plan did not provide equity holders equal treatment as required under section 1123(a)(4) of the Bankruptcy Code because the ad hoc group was receiving different and more favorable treatment than other similarly situated shareholders. The debtors argued that the participation right was not part of the plan treatment, but rather, it was an agreement by the investor noteholders to share a portion of their equity purchase commitment to avoid what might otherwise be an expensive valuation dispute that could result in a material delay, potentially putting the investor noteholders' equity at risk. The court overruled the objections.

Rights offerings were successfully used to effectuate confirmation of a plan in each of these cases. Rights offerings can also be used, however, to disadvantage certain parties. For instance, investment funds may have internal restrictions that prevent them from investing additional funds in a rights offering. To the extent that part of the real value given in exchange for a claim or interest is the right to participate in the offering, such parties can be diluted to their disadvantage. Rights offerings could be proposed as leverage against such parties in the context of restructuring negotiations.

Rights Offerings *continues on p. 16*

Rights Offerings *continues from p. 15*

Conclusion

Over the past few years, rights offerings have become an increasingly important tool for reorganizing debtors. Because of their inherent flexibility and value, rights offerings can be used to resolve disputes and benefit certain parties over others, in addition to raising new money for the reorganized company. Practitioners should be aware that offerings can be used both offensively and defensively, and they should remain cognizant of the increased creative use of the rights offering process to best protect their client's position. ■

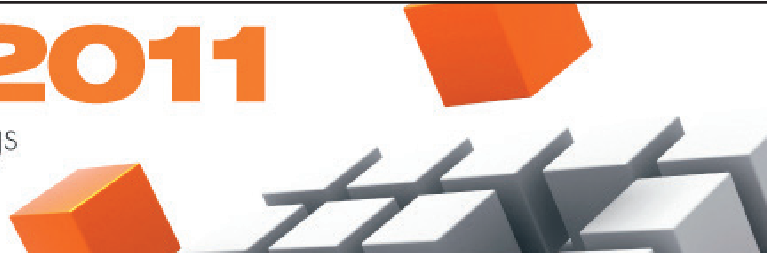
Daniel (Dan) Winikka is a partner in the Dallas office of Jones Day and has more than 14 years of experience representing debtors, creditors' committees, secured creditors, unsecured creditors and acquirers in complex business restructuring and bankruptcy matters. He has substantial experience representing clients in a variety of industries in chapter 11 reorganizations and liquidations, complex bankruptcy-related litigation, and the sale of assets and businesses of entities in bankruptcy, including both debtors/sellers and third-party acquirers. He can be reached at dpwinikka@jonesday.com. Paul M. Green is an associate in Jones Day's business restructuring and reorganization practice, resident in the Dallas office. His practice focuses on bankruptcy, corporate restructuring, and insolvency-related matters, with an emphasis on the representation of debtors, major creditors, and asset purchasers in chapter 11 proceedings. He can be reached at pmgreen@jonesday.com. The views presented in this article are the personal views of the authors and do not necessarily reflect those of Jones Day.

VALCON2011

Volatility, Valuations and Restructurings

February 23~25, 2011

Four Seasons Hotel, Las Vegas



Wednesday, February 23
Technical Valuation Workshop

1:00 p.m.
APPLICATION OF DISCOUNTS AND PREMIUMS (1.50 HRS)

2:30 p.m.
REFRESHMENT BREAK

2:45 p.m.
SUFFICIENCY OF CAPITAL TESTS IN THE CONTEXT OF AVOIDANCE ACTIONS (1.25 HRS)

4:00 p.m.
REFRESHMENT BREAK

4:15 p.m.
COST OF CAPITAL: AN ANALYSIS OF COURTS' INTERPRETATIONS (1.50 HRS)

5:45 p.m.
ADJOURN

5:45-7:15 p.m.
VALCON OPENING NETWORKING RECEPTION

Thursday Morning, February 24

8:30 a.m.
REGULATORY KEYNOTE: WILL DODD-FRANK REDUCE SYSTEMIC RISK? (.50 HRS)

9:00 a.m.
MARKET PARTICIPANT BEHAVIOR IN THE WAKE OF DODD-FRANK

10:15 a.m.
INVESTORS' ROUNDTABLE (1.33 HRS)

11:35 a.m
ADJOURN TO LUNCHEON AND PRESENTATION

Thursday Afternoon, February 24

12:10 p.m.
KEYNOTE LUNCHEON: CURRENT ISSUES INVOLVING FINANCIAL MARKETS AND REGULATION (.83 HRS)

1:15 p.m.
TEN PRACTICE TIPS FOR VALUATION PROFESSIONALS (.83 HR)

2:05 p.m.
REAL ESTATE RESTRUCTURINGS: THE ISSUES AND CHALLENGES RAISED BY COMPLEX MULTI-TRANCHE STRUCTURES (1.25 HRS)

3:35 p.m.
RIGHTS OFFERINGS (.83 HR)

4:25 p.m.
NAVIGATING MUNICIPAL RESTRUCTURINGS ROUNDTABLE: THE NEW FRONTIER

5:45-7:00 p.m.
NETWORKING RECEPTION

Friday Morning, February 25

8:30 a.m.
JUDICIAL PANEL (1.00 HR)

9:45 a.m.
NAVIGATING THROUGH THE ETHICAL MAZE OF FIDUCIARY DUTIES: RATTING ON CLIENTS AND OTHER HAZARDS (1.00 HR)

10:45 a.m.
DEALING WITH APPRAISALS AND COMPARABLES IN A VOLATILE MARKET (.75 HRS)

11:30 a.m.
ADJOURN

Conference Hotel
The Four Seasons Hotel Las Vegas

Travel
Air: Fly into McCarran International Airport (LAS).

Continuing Education
Approval for approximately 15 hours of CLE credit, including 1 hour of ethics, is pending. CPE credit is also available and approved for 17.5 credit hours. Mark the appropriate box on the registration form. California MCLE–ABI certifies that this activity has been approved for MCLE credit by the State Bar of California in the amount of 15.25 hours.

Registration
http://ABIWorld.org/VALCON11

EBITDAR as a Financial Health Indicator for Franchises and Retailers

David M. Bagley
MorrisAnderson

One trick marketers use to generate awareness or gain credibility is to define a market so narrowly that they can make a plausible claim that they are number one. Consider how many car dealerships claim superiority in a big suburban area. On a personal level, my wife and I often tell our three children that we are by far the best parents they will ever have.

The financial measure of EBITDA (Earnings Before Interest Taxes Depreciation and Amortization) follows this concept. Slice and dice the data conveniently enough, and any company can appear successful. Simply put, EBITDA means that a company is profitable before:

- Interest or principal paid to investors or lenders, meaning not having to pay for the capital required to start and operate the business;
- Taxes;
- Depreciation; and
- Amortization of debt or other value associated with the start up of the business or acquisitions used to grow the business.

Therefore, from a slightly cynical standpoint, EBITDA means: the company is not earning enough to show a positive net income, but if properly defined, it can proclaim it is making money. EBITDA plays a critical role in evaluating businesses that are undergoing change, and is often used in mergers and acquisitions as an alternative for earnings before capital costs and income taxes. But is it always the best alternative measure of financial health?

In the franchise industry, businesses are often evaluated using EBITDAR or EBITDA plus Rent as the "R." EBITDAR serves a distinct purpose in the retail world and actually helps make analyses involving the profitability of retail locations much more clear and concise.

Understanding Costs Associated with Store-Level Operations

In retail finance, store-level operations are the critical measure of success or failure. Inadequate merchandising and ineffective strategy at the corporate level can be overcome by a decent location and capable store management. Conversely, the best products can gather dust on shelves of poorly run storefronts in low-traffic locations. Therefore, store-level profitability is probably the single most meaningful measure of the near-term financial viability of a retail company.

Store-level profitability takes into account the ability of store management to drive local sales, control the cost of goods sold (including costs of products purchased and/or costs of direct production or service supplies), utilize labor effectively and monitor the direct costs of running the location, including day-to-day supplies, repairs and utilities. These costs are typically grouped as "controllable costs."

There are also location-specific costs, such as real estate taxes, common-area maintenance charges and lease and rent costs, which retailers typically call "uncontrollable costs." Given the dramatic increases in property costs during the last decade, most people would agree that occupancy costs are part of the "uncontrollable" economy. However, the definition actually refers to costs that are "uncontrollable by store-level management."

Complicating matters is that rent paid on a retail location can be tricky to calculate, due to the different types of rent and the various accounting rules associated with reporting rent costs, which are generally divided into two categories:

1. Third-party lease payments, which may or may not include costs related to:
   - Amortization of build-out or tenant-incentive monies
   - Property taxes
2. Owned property rents, which may or may not include costs related to:
   - Amortization of principal on real property debt
   - Payments to closely held entities owned by the operating company owners which include interest plus amortization of principal, taxes and other payments
   - Profit on the lease or owner dividends disguised through lease payments

Given the many potential components of rent, EBITDA analysis may require portions of that expense to be reinserted into the total operating costs, thereby changing EBITDA projections. Those adjustments complicate what should be a fairly simple calculation and often lead to internal confusion.

Finally, this already complicated situation is further confused by the accounting treatment of both leased and owned properties. Under FAS 13, the GAAP accounting rules that retailers use to account for capitalized leases force a reconciliation of cash payments to accrued expenses to ensure that all of the cost components are accounted for. If these adjustments are not taken into account, profitability may be understated in the short term and overstated in the long term.

Much of this confusion can be lessened if retail companies utilize EBITDAR as a measure of financial health, rather than the standard measure, EBITDA.

EBITDAR *continues from p. 17*

Why EBITDAR?

EBITDAR can be used to analyze store-level profitability and to more efficiently determine if a property can be made profitable or is a candidate for closure. For example, using EBITDAR MorrisAnderson has developed a store cash-flow analysis to evaluate numerous franchise and retail clients (see table below). It evaluates retail locations by sorting them from highest to lowest profitability, as follows:

Stores with Positive Earnings

These locations represent a foundation for future growth, whether that is through franchise portion of a potential sale.

Stores with Positive EBITDAR

These locations should be reviewed to determine how profitable they could be if rent concessions were acquired.

- In the restaurant industry, if rent at a specific store location represents 7 percent or less of sales, which corresponds to full occupancy costs of about 10 percent of sales, then in the long term, the location should be profitable.
- If the rent at store locations with a positive EBITDAR can be reduced to 7 percent of the location's sales through negotiations with the landlord, the location will likely be profitable in the long term and should be retained as a core unit.

Stores with Negative EBITDAR

The stores that would not be profitable even after achieving rent concessions represent a group that is operationally unsound and necessitates an operational revamp or closure. Unless these stores are in startup mode, they are deeply distressed and are prime candidates for immediate closure.

- As a standard rule of thumb, assuming a normalized rent of 7 percent of sales if a standard real estate capitalization rate valuation of 9-10 percent is applied, then the value of the real property cannot be more than about 85-90 percent of annual sales or an acute location issue results.

Sample Financial Health Analysis Utilizing EBITDAR

	Store	Total Net Sales	EBITDAR	Capex	Rent	Lease Payments	level Cash Flow	Adjusted 7% Rent	Store level Cash Flow
Group 1 Positive Net Cash flow									
1	506	$ 2,728	$ 524	$ 7	$ 183	$ 89	$ 246		$ 246
2	507	2,384	512	7	89	-	416		416
3	511	3,092	752	7	203	90	452		452
4	513	2,703	692	7	259	96	331		331
5	803	2,868	581	7	268	96	211		211
		13,775	3,061	35	1,001	370	1,655		1,655
Group 2 - Profitable with rent concessions									
6	201	1,551	220	7	179	63	(29)	109	41
7	802	2,724	606	7	550	90	(41)	191	318
8	801	2,043	316	7	350	85	(126)	143	81
		6,318	1,142	21	1,079	239	(197)	442	440
Group 3 - Unprofitable even with rent concessions									
9	312	2,167	231	7	162	90	(28)	152	(18)
10	503	1,366	98	7	161	-	(70)	96	(5)
11	401	1,723	215	7	216	90	(99)	121	(3)
12	708	1,550	153	7	230	90	(174)	108	(53)
13	711	2,036	320	7	276	210	(173)	143	(40)
		8,843	1,016	35	1,044	481	(544)	619	(119)
Total		$ 28,936	$ 5,219	$ 91	$ 3,125	$ 1,089	$ 914		$ 1,977

EBITDAR Is an Important Step, Not the "Be All End All"

Usually, this cash flow analysis provides a very clear picture of where the company stands as to what is required for a successful turnaround. However, as with all financial analyses, this is only one step in the complex turnaround process.

After undergoing this cash-flow analysis utilizing EBITDAR as an evaluation criterion, internal steps such as identifying and implementing appropriate operational changes (including sales and marketing efforts), strategic and tactical initiatives, operational efficiencies and system modifications should be undertaken at the store location before considering refinancing or restructuring options.

If, after the above internal steps are taken, refinancing or restructuring are deemed the only options, EBITDAR can be used to help guide these decisions.

- First, third-party rents are taken out of the EBITDAR number as an expense that cannot be changed without external assistance.
- From this adjusted EBITDAR, a store location's true cash flow can be evaluated. This is achieved after determining how to accommodate debt obligation payments related to the owned locations.
- Finally, when combined with operational improvements that are fundamental to a successful turnaround effort, final decisions can be made about suitable refinancing or restructuring strategies.

Conclusion

Utilizing EBITDAR as an appropriate evaluation criterion for store-level profitability in multi-unit retail companies makes assessing client situations easier and therefore leads to quicker development of turnaround strategies and options. However, as with all strictly financial analyses, the conclusions need to be validated with store management and corroborated by key location-specific information, such as area demographics, employment trends, strength of local management, competitiveness in the local market and other mitigating or extenuating criteria which may impact the conclusions of strictly financial analyses.

Although utilizing EBITDAR to evaluate store-level operations is not the "be all end all" of profitability analyses, it does offer a common basis for more efficient operational evaluations. Using this as a reference point allows more time and energy to be focused on determining the next steps, developing strategies and implementing successful changes that will provide the heart of a solid turnaround plan. ■

David M. Bagley is a Managing Director at MorrisAnderson, and can be reached at dbagley@morrisanderson.com. David has a specialized expertise in assisting companies in the franchise industry, and has served as a consultant, interim manager and financial advisor for turnarounds and workouts, restructurings and helping financially-distressed and underperforming companies achieve successful outcomes. David is a Certified Turnaround Professional (CTP) and is active in the Turnaround Management Association, Chicago chapter where he is currently a co-chairman of the CTP Committee.

Bankruptcy Taxes

Forrest Lewis
Plante & Moran PLLC

TAX MOTIVATED POISON PILL APPROVED IN SELECTICA

While the hostile take-over legal defense measure known as a "poison pill" is not very common in the tax area, a tax motivated poison pill was recently upheld by the Delaware Supreme Court in *Versata Enterprises Inc. v. Selectica Inc.*, C.A. No. 193, 2010 (Del. 10/4/10). The poison pill, more properly known as a shareholder rights plan, is a kind of defensive tactic used by a corporation's board of directors against a takeover. In the field of mergers and acquisitions, shareholder rights plans were devised in the early 1980s as a way for directors to prevent takeover bidder negotiating a price for sale of shares with shareholders, and instead forcing the bidder to negotiate with the board. Shareholder rights plans are not allowed in all jurisdictions but have been allowed if used "proportionately" in *Delaware*. The typical shareholder rights plan involves a resolution where shareholders will have the right to buy more shares at a discount, if one shareholder buys a certain percentage of the company's shares. The plan could be triggered, for instance, when any one shareholder buys up 15% or 20% of the company's shares, at which point every other shareholder (except the one who just acquired the 15%) will have the right to buy a new issue of shares at a discount. The plan is issued by the board as an "*option*" or a "*warrant*" on existing shares. Obviously, that is a strong deterrent for any party trying to execute an unwelcome takeover.

Because unwelcome buyers usually just go away after the pill has been effected, actual litigation on this is rare. The Board of Directors of Selectica Inc. adopted a shareholder rights plan aimed at protecting $165 million in NOLs. Prior to the litigation, Selectica and Trilogy (Versata) had long been competitors and maintained a "complicated" and "adversarial" relationship in the corporate software industry replete with patent suits and other controversy. Since its initial public offering in March 2000, Selectica had consistently operated at a loss and accrued approximately $165 million in NOLs. Federal tax law allows a corporation to use its NOLs to offset profits for up to 20 years. However, Congress has enacted Internal Revenue Code Section 382 to prevent trafficking in net operating losses. That section imposes significant limitation on the use of NOL carryforwards in the event of an "ownership change." An ownership change occurs when shareholders owning 5 percent or more of a corporation's stock acquire more than 50 percent of the outstanding stock during any three-year period. As mentioned above, financial shareholder rights plans use arbitrary and remote amounts of ownership such as 15% to 20% for a trigger but in NOL protection plans are necessarily keyed to the 5% requirement.

[The same issue is sometimes seen in Chapter 11 reorganization cases where the debtor has significant NOL carryforwards. In those cases the Plan of Reorganization sometimes contains legal restrictions on trading in the debtor's stock to prevent an "ownership change" under Sec. 382 from taking place.–FL]

By mid-2008, approximately 40 percent of Selectica's Section 382 qualifying stock had already changed hands, leaving the company's $165 million NOL asset at great risk of crossing the 50% threshold. After once again seeking to buy Selectica, or its assets, Trilogy began purchasing Selectica shares on the open market and within just a few weeks had purchased 1.5 million shares and become a 6 percent shareholder. Concerned that Trilogy's purchases had put its NOLs in jeopardy, the Selectica Board acted to protect its NOLs by amending its industry-standard 15 percent poison pill trigger to 4.99 percent in order to preempt a Section 382 change in ownership.

When Trilogy acquired the 6% it triggered a ten business day clock under the terms of the NOL Poison Pill. If the Board took no action during that time, then the rights (other than those belonging to Trilogy) would "flip-in" and become exercisable for deeply discounted common stock. Alternatively, the Board had the power to exchange the rights (other than those belonging to Trilogy) for newly-issued common stock, or to grant Trilogy an exemption. Three times in the two weeks following the triggering, Selectica offered Trilogy an exemption in exchange for an agreement to stand still and to withdraw its threat to impair the value and usability of Selectica's NOLs. Three times Trilogy refused and insisted instead that Selectica repurchase its stock, terminate a license agreement with an important client, sign over intellectual property, and pay Trilogy millions of dollars. After three failed attempts to negotiate with Trilogy, it was reasonable for the Board to determine that they had no other option than to implement the NOL Poison Pill. Selectica put the poison pill into effect implementing a distribution of stock rights to shareholders except Trilogy and the subsequent issuance of new stock diluted Trilogy's interest from 6.7% to 3.3% causing Trilogy to challenge the legality of the poison pill in court.

Delaware Supreme Court decision

The Court based its decision primarily on a previous Delaware decision, *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 957 (Del. 1985). The Court heard testimony that more than 50 public companies had implemented NOL poison pills with triggers at roughly 5%, including several large, well-known corporations, some among the Fortune 1000. The Court analyzed the Selectica case in terms of four criteria found in Unocal:

1. Selectica had reasonable grounds for concluding that a threat to the corporate enterprise existed. The Selectica Board concluded that the NOLs were an asset worth preserving and their protection was an important corporate objective.

2. Selectica's defensive response to the threat was not preclusive nor coercive of Trilogy's opportunity to acquire Selectica.

Taxes continues from p. 19

3. The response was "reasonable in relation to the threat" identified. A defensive measure is disproportionate and unreasonable per se if it is draconian by being either preclusive or coercive.

4. If a defensive measure is neither coercive nor preclusive, the Unocal proportionality test "requires the focus of enhanced judicial scrutiny to shift to 'the range of reasonableness." Where all of the defenses "are inextricably related, the principles of Unocal require that such actions be scrutinized collectively as a unitary response to the perceived threat." The Selectica Board carried its burden of proof.

The Court concluded with this warning about interpretations of the decision: "The fact that the NOL Poison Pill was reasonable under the specific facts and circumstances of this case, should not be construed as generally approving the reasonableness of a 4.99% trigger in the Rights Plan of a corporation with or without NOLs."

[Commentary: in Revenue Ruling 90-11the IRS ruled on the distribution of the options to acquire more stock in a defensive dilution action. The ruling held that the rights distribution itself is not a taxable dividend but disclaims any guidance on the taxability to the shareholders of any subsequent dilutive issuance of shares. It is thought that this ruling is on the more traditional financial poison pill plan with a 15% or 20% trigger which is a remote circumstance. It is not clear what position the IRS might take on a NOL defense plan with a trigger under 5%.–FL] ■

Thanks to Katherine Bristor, attorney, for her insights. Thanks to Dennis Bean and Grant Newton for their assistance with this article.

INDIVIDUAL–IRS PENSION PLAN LIENS HARD TO SHAKE

While an individual taxpayer may have his federal income taxes for a year discharged in bankruptcy, that does not affect a federal tax lien as Grant Newton always teaches us. Two recent Tax Court decisions illustrate that liens can be imposed in some cases after bankruptcy and just how difficult those liens are to shake. In both cases the taxpayer's pension plan was excluded from the estate, not exempted. In both cases "old" federal tax liabilities were discharged in Chapter 7 proceedings. But in both cases the Court held the "automatic" lien of Sec. 6321 applied even if the Notice of Federal Tax Lien issued by the Internal Revenue Service after the case was closed. IRS was then allowed to levy on the pension account to collect the "old" taxes. While the Employee Retirement Income Security Act of 1974 (ERISA) generally protects retirement benefits from creditors, there is at least one major exception—tax liabilities owed to the IRS.

Here is the "automatic" lien of Internal Revenue Code Sec. 6321:

"LIEN FOR TAXES -If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount (including any interest, additional amount, addition to tax, or assessable penalty, together with any costs that may accrue in addition thereto) shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person."

In the first case, *Wadleigh v. Commissioner*, T.C., No. 10783-07L, 134 T.C. No. 14, 6/15/10, a Mr. Vance Wadleigh filed a 2001 Federal income tax return on August 16, 2002, that showed a Federal income tax liability and a balance due. The Internal Revenue Service assessed the liability and issued a timely notice and demand for payment on September 16, 2002 but the taxes were not paid. In 2005, Mr. Wadleigh filed a petition in Chapter 7. On Schedule B, personal property, of his bankruptcy petition Mr. Wadleigh listed his interest in his Honeywell pension plan, however he claimed the pension as exempt property on Schedule C. At the time he filed for bankruptcy Mr. Wadleigh was fully vested in his pension plan, but it was not yet in payout status. Mr. Wadleigh contended that his pension plan was excluded from the bankruptcy estate pursuant to Bankruptcy Code sec. 541(c)(2) or alternatively claimed that his pension was exempt property, but only if and to the extent that his pension was includable in the bankruptcy estate. On December 8, 2005 he was granted a discharge which included his 2001 income tax liability. On January 29, 2007, more than 9 months before Mr. Wadleigh's pension entered payout status, IRS mailed him a Notice of Intent to Levy with respect to 2001. Mr. Wadleigh then took the fight to the U.S. Tax Court.

On June 15, 2010, Judge Marvel ruled that despite the fact that the pension plan was listed with exempt property, it was in fact property excluded from the bankruptcy estate by law [despite the fact that qualified retirement benefits are listed with exempt property in sec. 522.] Further, while Wadleigh's discharge in bankruptcy relieved him of personal liability for the unpaid 2001 Federal income tax, the discharge does not prevent IRS from collecting Wadleigh's unpaid 2001 Federal income tax by levy on his pension income, notwithstanding the failure to file a valid notice of Federal tax lien with respect to 2001 prior to the bankruptcy petition. The post discharge lien was sufficient. The Judge went on to rule IRS must wait to levy on the pension until it enters payout status.

The second case, *Stuart A. Gross v. Commissioner,* TC Memo. 2010-176, August 5, 2010, involved Federal income taxes for 1998, 1999, 2000, and 2001 which totaled $270,041.15. On October 16, 2005, Mr. Gross filed a petition under chapter 7. At that time, Mr. Gross owned an interest in an ERISA-qualified pension plan from the Director's Guild of America valued at $300,000 which was listed on Schedule B, Personal Property, attached to the bankruptcy petition. On Schedule C, Property Claimed as Exempt, also attached to the bankruptcy petition, petitioner listed as exempt the full value of his interest in the DGA plan. The petitioner included the following description on Schedules B and C: "This is an ERISA Qualified Pension Plan which is not property of the estate but in an abundance of caution has been listed herein and exempted."

On June 2, 2006, the bankruptcy court entered an order of discharge pursuant to B.C. sec. 727. On August 7, 2006, the bankruptcy court entered an order closing petitioner's bankruptcy case. That same day the IRS sent petitioner a Notice of Intent to Levy. Since IRS

had not filed a notice of Federal tax lien prior to his Chapter 7 petition, the parties stipulated that Mr. Gross had no present personal obligation to pay the Federal income tax liabilities.

Judge Vasquez upheld the IRS levy in a summary judgment. In a very lucid opinion he ruled "Bankruptcy Code sec. 541(c)(2) permits a debtor to exclude an interest in an ERISA-qualified pension plan from his bankruptcy estate. In addition, B.C. sec. 522 allows a debtor to exempt from his bankruptcy estate certain property, including retirement funds, to ensure that the debtor has at least some property with which to make a fresh start. Property that is exempt from the bankruptcy estate pursuant to sec. 522 such as an auto, a homestead, household goods, etc. is not available to satisfy prepetition debts during or after the bankruptcy, except debts secured by liens that are not avoided in the bankruptcy and *section 6321 liens with respect to which an NFTL has been filed.* Unlike exempt property, excluded property never becomes part of the bankruptcy estate and is therefore never subject to the bankruptcy estate trustee's or the debtor's power to avoid the section 6321 lien. Thus if a section 6321 lien on excluded property has not expired or become unenforceable under section 6322, it survives the bankruptcy. As noted in *Wadleigh*, there is no formal procedure within the bankruptcy process to clarify what property is excluded, and confusion has resulted from this lack of clarity. Simply listing an ERISA-qualified pension plan account, an excludable asset, on Schedule C is not necessarily sufficient to claim an exemption if all of the facts, including any statements made on the bankruptcy schedules, indicate that the debtor excluded the ERISA-qualified pension plan account from his bankruptcy estate."

Conclusion

These cases illustrate that for IRS to reach property which was treated as exempt in a bankruptcy, a notice of federal tax lien has to pre-date the filing of the petition in bankruptcy. To reach property which was excluded from the bankruptcy estate such as a qualified retirement plan or IRA, a federal tax lien can be filed any time before the pension is completely paid out, assuming that is within the statute of limitations for federal tax liens. ■

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

ACCELERATION OF DEFERRED COD UNDER 108(i)

Now that the period to elect the cancellation of debt deferral under Internal Revenue Code Section 1089(i) is ending, attention is turning to what events can trigger acceleration of the tax. Taxpayers who made the election to defer taxable COD income to a five year period starting in 2014 will want to avoid certain conditions and transactions which could trigger immediate taxation of the deferred income. The Internal Revenue Service recently issued temporary regulations detailing those rules–Reg. 1.108-1T and 1.108-2T. The preamble to the -1T regulation contains this interesting paragraph:

> Accordingly, while these temporary regulations do not require acceleration in every instance enumerated in the statute, they provide instead for acceleration in a limited number of circumstances in which corporations have impaired their ability to pay their incipient tax liability. This approach is broadly consistent with the approach advanced by commentators who suggested, for example, that a transfer of a corporation's business assets for stock in a section 351 exchange should not be an acceleration event, despite the literal language of section 108(i)(5)(D).

It may be that IRS is signaling that it will not demand acceleration in those cases enumerated in the statute but not listed in the regulation.

Here is a highly summarized list of the acceleration events or conditions:

A. Change in tax status of the taxpayer-e.g. C corp elects S corp status, a C corporation that becomes a tax-exempt entity, or a C corporation that begins operating as a cooperative.

B. Ceases existence-e.g. death of an individual taxpayer who had made the election for business indebtedness, liquidation of corporation except for certain taxfree transactions under IRC Sec. 381. If an electing corporation ceases to do business, liquidates or sells substantially all of its assets in a proceeding under title 11 (or a similar case), the corporation's deferred items are taken into account the day before the petition is filed. The IRS stated that the acceleration rules are sufficient to protect the collectability of tax relating to deferred COD income. Accordingly, no special acceleration rules for an electing corporation in a title 11 or similar case are provided.

C. Engages in impairment transaction--after which gross asset value is less than 110% of the total liabilities plus tax on net amount of deferred items. Impairment transactions are any transactions, however effected, that impair an electing corporation's ability to pay the amount of Federal income tax liability on its deferred COD income and include, for example, distributions (including certain section 381(a) transactions), redemptions, below market sales, unusual donations, and the incurrence of additional indebtedness without a corresponding increase in asset value. However, value-for-value sales or exchanges [including, for example, an exchange to which section 351 (taxfree incorporations) or section 721 (taxfree contributions of assets to a partnership) applies] are not impairment transactions. Under this rule, an electing corporation's investments and expenditures in pursuance of its good faith business judgment are not impairment transactions, merely because, for example, acquired assets are riskier or less liquid than the electing corporation's previous assets. In addition, mere declines in the market value of an electing corporation's assets are not impairment transactions. Although the decline may impair an electing corporation's ability to pay its tax liability, a different rule would require continuous valuations and is contrary to the transactional approach taken in the statute and these regulations, and the realization requirement generally.

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The net value acceleration rule has a mitigating provision that allows an electing corporation to avoid accelerated inclusion of its deferred COD income if value is restored to the corporation by the due date of the electing corporation's tax return (including extensions). In general, the amount required to be restored is the lesser of: (i) the amount of value that was removed (net of amounts previously restored under this rule) from the electing corporation in one or more impairment transactions; or (ii) the amount by which the electing corporation's net value floor exceeds its gross asset value. For example, assume an electing corporation incurs $50 of indebtedness, distributes the $50 of proceeds to its shareholder, and immediately after the distribution, the electing corporation's gross asset value is $25 below the net value floor. The electing corporation may avoid application of the net value acceleration rule if, as a result of a transaction, assets with a value of $25 are restored to the corporation before the due date of its tax return (including extensions) for the taxable year that includes the distribution. For purposes of this provision, the value that must be restored is determined at the time of the impairment transaction, and is determined upon a net value basis (for example, additional borrowings by an electing corporation do not restore value).

Special Rules for Consolidated Corporations

The determination of whether an electing corporation that is a member of a consolidated group (electing member) has engaged in an impairment transaction is made on a group-wide basis. Thus, an electing member is treated as engaging in an impairment transaction if any member's transaction impairs the group's ability to pay the tax liability associated with the group's deferred COD income; accordingly, intercompany transactions are not impairment transactions. Similarly, the net value acceleration rule is generally applied by reference to the gross asset value of all members.

Special rules are provided when an electing member that previously engaged in an impairment transaction on a separate entity basis leaves a consolidated group. If the electing member ceases to be a member of a consolidated group, the cessation is treated as an impairment transaction and the net value acceleration rule is applied on a separate entity basis (by reference to the assets, liabilities, and deferred items of the electing member only) immediately after it ceases to be a member. If the electing member's gross asset value is less than the net value floor, then the electing member's remaining deferred COD income must be taken into account immediately before the electing member ceases to be a member (unless value is restored).

Special rules for Partnerships and S corps The COD deferral election rules for partnerships and S corps allow a partner by partner election of any deferral. Then if any of the acceleration events listed above occur in an electing partnership or S corporation all of the deferred items of the electing partnership or electing S corporation are accelerated and must be taken into account in the taxable year in which the event occurs by the partners or shareholders who had made deferral elections. Additional acceleration events that apply to the partners or shareholders of an electing partnership or S corporation include the sale, exchange, or redemption of an interest in the electing entity. If any of these separation events occur, the deferred items allocated to the partner or S corporation shareholder that sells, exchanges, or redeems its interest must be taken into account by such partner or shareholder in the taxable year in which the event occurs. Since any partnership basis or stock basis increase related to the COD income was not allowed at the time of the election, it is allowed in the year of acceleration. ■

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

Forrest Lewis, CPA, Section Editor, is a tax practitioner based in East Lansing, Michigan

Bankruptcy Cases

Baxter Dunaway

SUPREME COURT:
United States Patents

Is a claimed invention that explains how buyers and sellers of commodities in the energy market can protect, or hedge, against the risk of price changes and that reduces this concept of hedging to a mathematical formula a patentable "process" eligible for a United States patent?

The Supreme Court held that a claimed invention that explains how buyers and sellers of commodities in the energy market can protect, or hedge, against the risk of price changes and that reduces this concept of hedging to a mathematical formula was an "abstract idea," and thus was not a patentable "process." *Bilski v. Kappos*, — S.Ct. —, 2010 WL 2555192 (U.S. Jun 28, 2010) (NO. 08-964).

Syllabus

Petitioners' patent application seeks protection for a claimed invention that explains how commodities buyers and sellers in the energy market can protect, or hedge, against the risk of price changes. The key claims are claim 1, which describes a series of steps instructing how to hedge risk, and claim 4, which places the claim 1 concept into a simple mathematical formula. The remaining claims explain how claims 1 and 4 can be applied to allow energy suppliers and consumers to minimize the risks resulting from fluctuations in market demand. The patent examiner rejected the application on the grounds that the invention is not implemented on a specific apparatus, merely manipulates an abstract idea, and solves a purely mathematical problem. The Board of Patent Appeals and Interferences agreed and affirmed. The Federal Circuit, in turn, affirmed. The *en banc* court rejected its prior test for determining whether a claimed invention was a patentable "process" under Patent Act, 35 U.S.C. § 101-*i.e.,* whether the invention produced a "useful, concrete, and tangible result," see, *e.g., State Street Bank & Trust Co. v. Signature Financial Group, Inc.*, 149 F.3d 1368, 1373 (D.C. Cir. 1998)-holding instead that a claimed process is patent eligible if: (1) it is tied to a particular machine or apparatus, or (2) it transforms a particular article into a different state or thing. Concluding that this "machine-or-transformation test" is the sole test for determining patent eligibility of a "process" under § 101, the court applied the test and held that the application was not patent eligible.

Held: The judgment is affirmed.

SUPREME COURT:
Bankruptcy

Is an unsecured claim for postpetition attorney's fees, authorized by a valid prepetition contract, allowable under § 502(b) of the Bankruptcy Code?

The U.S. Supreme Court denied the petition for certiorari from a Second Circuit decision[1] which ruled that an unsecured claim for postpetition attorney's fees, authorized by a valid prepetition contract, is allowable under § 502(b) of the Bankruptcy Code and is deemed to have arisen prepetition. *Ogle v. Fidelity & Deposit Co. of Maryland*, Ogle v. Fidelity & Deposit Co. of Maryland, 2010 WL 531913 (U.S. 2010).

SECOND CIRCUIT

May district courts issue anti-litigation injunctions barring bankruptcy filings as part of broad equitable powers in the context of a Securities and Exchange Commission receivership?

District courts may issue anti-litigation injunctions barring bankruptcy filings as part of broad equitable powers in the context of a Securities and Exchange Commission receivership. *S.E.C. v. Byers*, 609 F.3d 87, Bankr. L. Rep. P 81,788 (2nd Cir.(N.Y.) Jun 15, 2010).

After Securities and Exchange Commission (SEC) brought civil fraud enforcement action against companies and individual defendants arising out of alleged Ponzi scheme, District Court entered temporary restraining order freezing defendants' assets, appointed temporary receiver, and entered anti-litigation and anti-bankruptcy injunctions. The United States District Court for the Southern District of New York, denied committees' motions to lift injunctions, and committees appealed. The Committees' primary argument on appeal was that Section 303 of the Bankruptcy Code grants them an absolute right, as creditors, to commence an involuntary bankruptcy proceeding against a debtor. The Committees argued that the district court lacked the authority to subvert this right by issuing the anti-litigation injunction. The Second Circuit disagreed, and found that while it is a power to be exercised cautiously, district courts may issue anti-litigation injunctions barring bankruptcy filings as part of their broad equitable powers in the context of an SEC receivership.

The Second Circuit joined both the Ninth and Sixth Circuits, which also allow similar anti-litigation injunctions. In *SEC v. Wencke*, the Ninth Circuit held that the authority of a district court to issue an order staying a non-party from bringing litigation derived from "the inherent power of a court of equity to fashion effective relief." 622 F.2d 1363, 1369 (9th Cir.1980). The Ninth Circuit stated that the power of the district court to issue a stay, effective against all persons, of all proceedings against the receivership entities rests as much on its control over the property placed in receivership as on its jurisdiction over the parties to the securities fraud action. *Id.* The Ninth Circuit concluded that if a district court could not control the receivership assets, the receiver would be unable to protect those assets. *Id.* The Sixth Circuit in *Liberte Capital Group, LLC v. Capwill,* 462 F.3d 543 (6th Cir.2006), came to a similar conclusion:

> Once assets are placed in receivership, a district court's equitable purpose demands that the court be able to exercise control over claims brought against those assets. The receivership court has a valid interest in both the value of the claims themselves and the costs of defending any suit as a drain on receivership assets. To this extent, the receivership court may issue a blanket injunction, staying litigation against the named receiver and the entities under his control unless leave of that court is first obtained. This power extends to the institution of any suit, and not just a proceeding for execution of

1 Ogle v. Fidelity & Deposit Co. of Maryland, 586 F.3d 143, 52 Bankr. Ct. Dec. (CRR) 89, 62 Collier Bankr. Cas. 2d (MB) 1247, Bankr. L. Rep. (CCH) P 81617 (2d Cir. 2009), cert. denied, 2010 WL 531913 (U.S. 2010).

Bankruptcy *continues from p. 23*

a judgment against the receivership in the receivership court. Because the court's power of injunction in a receivership proceeding arises from its power over the assets in question, non-parties to the underlying litigation may be bound by a blanket stay, so long as the non-parties have notice of the injunction. *Id.* at 551-52 (internal citations and quotations omitted).

Research References: Bankruptcy Service, L. Ed. §§ 13:222, 14:57, 14:58, 14:59, 14:60, 14:61, 14:62, 14:63; Norton Bankr. L. & Prac. 3d §§ 22:1, 22:6, 22:11, 92:4, 171:4; Norton Bankr. L. & Prac. 3d 11 U.S.C. §§ 303, 543; Bankruptcy Law Manual 5d §§ 2A:21, 2A:22, 4A:5.

THIRD CIRCUIT

Does the existence of § 365(d)(3) preclude the attempted use of § 503(b)(1) for "stub rent"? May "stub rent" be considered an administrative expense under § 503(b)(1)?

The Third Circuit held that 1) the existence of § 365(d)(3) does not preclude the attempted use of § 503(b)(1) for "stub rent" and 2) "stub rent" may be considered an administrative expense under § 503(b)(1). *In re Goody's Family Clothing Inc.*, 610 F.3d 812, Bankr. L. Rep. P 81,798 (3rd Cir.(Del.) Jun 29, 2010).

Commercial landlords that had entered into leases with Chapter 11 debtors that required prepayment of rent on first of every month moved for allowance as administrative expense and immediate payment of "stub rent" relating to that portion of month in which bankruptcy petition was filed which postdated the order for relief. Debtors opposed motion. The United States Bankruptcy Court allowed administrative expense claim, but denied landlords' request for immediate payment, and debtors appealed. The District Court affirmed and Debtors appealed.

The Court of Appeals held that:

(1) the section of the Bankruptcy Code requiring trustee to timely perform all obligations of debtor arising under any unexpired lease of nonresidential real property, from and after order for relief, until lease is assumed or rejected does not supplant or preempt the Code's administrative expense provision, and

(2) debtors' occupancy of the leased premises postpetition was an actual and necessary benefit to the estate and, thus, landlords were entitled to "stub rent" as an administrative expense.

For a discussion of the *Goody's* case *see* J. Kate Stickles**,** Patrick J. Reilley, Stub Rent: the Third Circuit's Decision in *Goody's*, 29-OCT Am. Bankr. Inst. J. 22 (Westlaw: 29-OCT AMBKRIJ 22) (October, 2010). The Conclusion of that article is as follows:[2]

> For now,[3] a landlord seeking the payment of stub rent must consider the jurisdiction in which the bankruptcy case is pending. The Third Circuit's decision in *Goody's* provides clarity with respect to the treatment of stub rent in the Third Circuit. In that circuit, a landlord must affirmatively seek payment of the stub rent as an administrative-expense claim under § 503(b)(1). To the extent the claim is challenged, the landlord must be prepared to meet its burden and establish that the rent obligation is an actual and necessary expense that benefits the estate. An administrative-expense claim under § 503(b)(1), however, need not be "timely paid."[4] Therefore, despite the award of an administrative claim for stub rent, a landlord may not be paid until the lease is assumed or a plan is confirmed.

Research References: Bankruptcy Service, L. Ed. §§ 21:434, 21:554, 21:556, 21:561, 21:641, 21:643, 21:645, 21:654, 23:550, 23:825, 23:836; Norton Bankr. L. & Prac. 3d § 46:42; Norton Bankr. L. & Prac. 3d 11 U.S.C. §§ 365, 503; Bankruptcy Law Manual 5d § 6:29.

FIRST CIRCUIT

Was sanction of $250,000 on lender which originated mortgage loan, for misrepresenting that it was "holder" of the mortgage, when it had assigned the mortgage and was only the servicing agent excessive?

2 29-OCT Am. Bankr. Inst. J. 22, at 75.

3 As of the submission of this article, the time to file a petition for a *writ of certiorari* to the Supreme Court has not expired. In the event such a petition were granted, a Supreme Court decision could resolve the split in authority with respect to the payment of stub rent.

4 *See, e.g., In re Midway Airlines Corp.*, 406 F.3d 229, 243 (4th Cir. 2005).

The First Circuit holds that sanction of $250,000 on lender which originated mortgage loan, for misrepresenting that it was "holder" of the mortgage, when it had assigned the mortgage and was only the servicing agent, was excessive and would be reduced to $5,000. *In re Nosek*, 609 F.3d 6, Bankr. L. Rep. P 81,789 (1st Cir.(Mass.) Jun 14, 2010).

The Court found that agent's claim that it was holder of the mortgage was not deliberate falsehood or intended in any way to mislead court or debtor or achieve anything for itself, agent arguably could have sued "as if" it were the holder, and debtor was not prejudiced. Although bankruptcy judge has broad discretion in setting sanctions, deference is not to be confused with automatic acquiescence, and reviewing court can find sanction unreasonable in itself or in amount. The Court cited Fed.Rules Bankr.Proc. Rule 9011, 11 U.S.C.A.

See generally Porter, *Misbehavior and Mistake in Bankruptcy Mortgage Claims,* 87 Tex. L.Rev. 121, 123-24 (2008). Bankruptcy courts have a legitimate interest in policing the filings submitted, and sanctions can sometimes serve a useful function in this endeavor. Steep sanctions might be appropriate were a lender shown to have routinely misrepresented its role in bankruptcy cases, caused unnecessary litigation, or prejudiced another party. *See* also Joseph, *Sanctions: The Federal Law of Litigation Abuse* § 16(D)(2) at 2-280 (4th ed.2008).

FIFTH CIRCUIT

Can a bankruptcy court certify a class action of debtors whose cases are pending within the district even though the cases are assigned to separate bankruptcy judges?

Fifth Circuit rules that a bankruptcy court may certify a class action of debtors whose cases are pending within the district even though the cases are assigned to separate bankruptcy judges. *Wilborn v. Wells Fargo Bank, N.A. (In re Wilborn),* 609 F. 3d 748, 754 (5th Cir. 2010) ("[B]ankruptcy court has authority to certify a class action of debtors whose petitions are filed within its judicial district provided the prerequisites for a class under Rule 23 are satisfied.").

Chapter 13 debtors brought adversary proceeding on behalf of putative debtor class against mortgage holder/servicer, alleging holder/servicer charged, or charged and collected, unreasonable and unapproved post-petition professional fees and costs during the pendency of their bankruptcies, and that holder/servicer's pattern and practice of charging such fees avoided court oversight of the charges and was contrary to the bankruptcy code, and the bankruptcy rules. The United States Bankruptcy Court for the Southern District of Texas granted debtors' motion for class certification. Subsequently, the class certification order was certified for direct appeal, and the holder/servicer's petition for permission to appeal was granted. The Court of Appeals held that:

(1) bankruptcy court had authority to certify debtors' class action;(2) questions of law or fact common to the class members did not predominate; and therefore(3) injunctive or declaratory relief was not appropriate for the class as a whole. Vacated.

SECOND CIRCUIT

Is a bankruptcy case commenced and the automatic stay triggered where the debtor has not obtained mandatory credit counseling?

Second Circuit holds that a case is commenced and the automatic stay is triggered where the debtor has not obtained mandatory credit counseling and remands to permit the bankruptcy court to determine whether it must dismiss rather than strike the petition.[5]

The Second Circuit decided that the United State's Trustee (UST) has standing to appeal the striking of debtors' bankruptcy petitions, as opposed to dismissal of their cases, where the debtors were ineligible to obtain bankruptcy relief for failure to have obtained mandatory credit counseling under Section 109(h), or a waiver or extension thereof. In determining the UST had standing to appeal, the Second Circuit noted that "the U.S. trustees are responsible for 'protecting the public interest and ensuring that bankruptcy cases are conducted according to law.' "[6]

The *Zarnel* opinion relies, in part, on Section 307 of the Bankruptcy Code, which authorizes the Trustee to "raise and [ ] appear and be heard on any issue in any case or proceeding under this title."[7] The opinion also juxtaposes this statutory mandate to the UST to protect the public interest with case law holding, in most circumstances, that "in determining whether a party has standing to appeal from a particular ruling of a bankruptcy court, we have frequently looked to whether an appellant is a "person aggrieved" that is, "a person ' directly and adversely affected pecuniarily by' the challenged order of the bankruptcy court."[8] The Second Circuit also noted, however, that pecuniary interest "is not the only test" and determined that the UST's role in the bankruptcy process is such that appellate standing to seek review of the striking of a bankruptcy petition versus dismissal of a bankruptcy case is appropriate.[9]

The Court further concluded that although an individual may be ineligible to be a debtor under the Bankruptcy Code for failure to satisfy the strictures of § 109(h), the language of § 301 does not bar that debtor from *commencing* a case by filing a petition; it only bars the case from being maintained as a proper voluntary case under the chapter specified in the petition.[10]

EIGHTH CIRCUIT

Is appeal challenging sale of debtor's assets under 11 U.S.C.A § 363(f) free and clear of liens moot under § 363(m) statutory provision barring any challenge to order approving sale of assets to good faith purchaser?

Appeal challenging sale of debtor's assets free and clear of liens was moot under statutory provision barring any challenge to order approving sale of assets to good faith purchaser; neither party obtained stay of sale pending appeal, and, because creditor's appeal occurred after sale had closed, successful challenge would have had effect of unwinding sale, even if it only resulted in preserving the creditor's lien against the sold assets. 1 U.S.C.A. § 363(f, m). *In re Polaroid Corp.*, 611 F.3d 438, Bankr. L. Rep. P 81,810 (8th Cir. (Minn.) Jul 09, 2010). ■

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

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5 *In re Zarnel*, 619 F.3d 156, Bankr. L. Rep. P 81,834 (2nd Cir.(N.Y.) Aug 26, 2010). *See also In re JNL Funding Corp.*, --- B.R. ----, 2010 WL 4243901 (Bankr.E.D.N.Y. Oct 28, 2010) (NO. 10-73724-AST).

6 *In re Zarnel,* 619 F. 3d 156, 2010 WL 3341428 at * 5(citing *In re Revco D.S., Inc.,* 898 F.2d 498, 499 (6th Cir.1990); *In re United Artists Theatre Co.,* 315 F.3d 217, 225 (3d Cir.2003); and *In re Plaza de Diego Shopping Ctr., Inc.,* 911 F.2d 820, 824 (1st Cir.1990)).

7 11 U.S.C. § 307; *In re Zarnel,* 619 F. 3d 156, 2010 WL 3341428 at * 4.

8 *In re Zarnel,* 619 F. 3d 156, 2010 WL 3341428 at * 4 (citing *Int'l Trade Admin. v. Rensselaer Polytechnic Inst.,* 936 F.2d 744, 747 (2d Cir.1991).

9 *In re Zarnel,* 619 F. 3d 156, 2010 WL 3341428 at * 4.

10 619 F.3d 156 at 166-167.

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Skokie, IL 60076
robert.cronin@reznickgroup.com

Andrew Domescik
One Embarcadero Center
San Francisco, CA 94904
ddomescik@validant.com

Michael Kennelly
Navigant
30 S. Wacker Suite 3100
Chicago, IL 60606
mkennelly@ncacf.com

Olaolu Odewole
Hunters Resources LLC
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Staten Island, NY 10312
olaodewole@gmail.com

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lpatt@traxi.com

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Brownstein Corporation
1721 N. Rodney St.
Wilmington, DE 19806
profisnc@gmail.com

James Proctor
Meridian Advantage
200 Ridge St., Suite 240
Reno, NV 89501
jsp@Madvantage.com

J. Bradley Sargent
The Sargent Consulting Group LLC
9550 Bormet Dr. Suite 204
Mokena, IL 0
BSargent@SCGForensics.com

Sam Slater
RBS Citizens Bank
1701 John F. Kennedy Parkway, 22nd Floor
Philadelphia, PA 19103
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