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An Introduction to Corporate Carve-outs

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As the global economy continues to stall, both healthy and distressed corporations are looking to divest struggling or non-core divisions. This process is called a "carve- out." Private equity and strategic buyers are increasingly purchasing these carved-out divested business units. Acquiring carved-out business units is more challenging than buying existing standalone businesses and there are a number of unique challenges. Strategic buyers usually have an existing business infrastructure into which they can run the business. Private equity buyers, on the other hand, need to develop this infrastructure so that the carved-out entity can operate.

WHY COMPANIES ARE CARVED OUT FROM CORPORATE PARENTS

Divisions of larger companies are sold or carved out for a variety of reasons, including:

- The parent would like to focus on other higher-growth, more "core" segments.
- The parent is in financial distress and needs to generate cash from a transaction. Oftentimes in Section 363 Bankruptcy auctions, only select assets or divisions are sold from the Debtor, which creates a carve-out situation.
- The parent needs to divest a unit due to regulatory or antitrust requirements (e.g. a parent merges with another entity and needs to divest one or more divisions in order to comply with regulatory requirements).

Carve-outs can be particularly interesting when a parent is divesting a business because it is non-core in the parent's current structure. These units may have been deprived of growth capital and have been in a "limbo" situation where there is a lack of strategic focus. Under new ownership, these carved-out units can thrive.

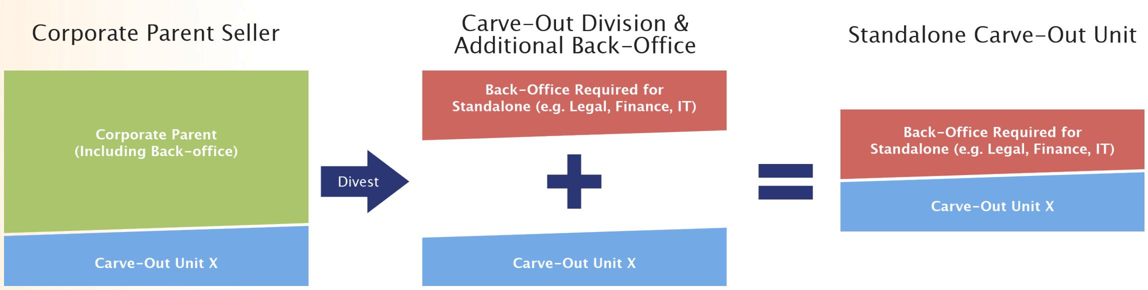
CARVING OUT A DIVISION

For all carve-out buyers there is a spectrum of how much integration and new infrastructure is required to stand up the business. Figure 1 illustrates the process. Key steps for a private equity sponsor to carve out a business include:

1. **Perform due diligence on the carved-out unit—**The first step in a carve-out is to perform due diligence on the carved-out unit. Similar to any acquisition transaction, it is crucial to review the division's finances, management team, sales and marketing strategy, product roadmap, intellectual property, and off balance sheet liabilities (e.g. pension obligations, litigation). One of the nuances of carve-out due diligence is that oftentimes the unit was not operated as a completely stand-alone business by the parent. This leads to the carved-out unit not having a full set of standalone financial statements. In some deals, the seller provides a carve-out audit of the unit. Carve-out audits estimate the direct revenues and costs as well as the corporate allocations. It is also necessary for the buyer to understand exactly what staff, locations, products, and other assets are included in the transaction.
2. **Finalize the deal structuring and close the transaction—**After due diligence is completed, the deal structure can be finalized.

Corporate Carve-outs continues on p. 3

Figure 1: Carve-Out Transaction Diagram



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***Carve-outs** continued from p. 1*

Transactions can be accommodated via asset or equity sales. Once terms have been negotiated and closing conditions have been satisfied, the buyer can take ownership of the carved-out division. After the business is legally transferred from the parent to the buyer, there is still significant work required to successfully integrate and complete the carve-out transaction.

3. **Stand up the carved-out entity's back office—**When a business is carved out of a corporate parent, it oftentimes is delivered without full back-office functions. The carved-out business usually comes with sales, R&D, marketing—segments directly related to that specific business unit—but lacks departments or divisions to provide support functions. For example, a carved out division often does not have its own Human Resources, Finance, IT, Legal, or supply chain. After the deal closes, it is necessary to quickly put these back-office functions into place on a permanent or temporary basis. Failure to have support functions in place can lead to problems in running and growing the newly carved out business. As part of the terms of sale, the existing parent frequently offers to provide back-office services for a fee in a "Transition Services Agreement." These agreements typically run from several months to a year and provide a smoother transition as the support functions are put into place. Oftentimes the new business will also require new legal entities be established and potentially a new trade name. It is also necessary for the firm to engage auditors and other professionals to assist with some of the normal back-office compliance.
4. **Develop a near-term strategic plan—**While the back-office is being built up, it is necessary to develop a budget and longer-term strategic operating plan to provide direction for the business. It is important to set key budget targets and develop a new organizational structure which fits the new scope, vision, and goals for the business.
5. **Restructure business—**After the strategic plan has been developed, the business may need to be restructured financially or operationally. For example, some parts of the carved out business may need to be shut down or divested and the management structure may need to be adjusted. It is helpful to execute the restructuring soon after closing to minimize disruption to the business. During the acquisition structuring, some elements of the business can be effectively restructured. For example, during the structuring of the transaction, certain offices, assets, and/or employees may be left with the parent. This changes the starting point for the business. In many transactions, the carved-out business will need to obtain new financing to fund the working capital and capital expenditure requirements.
6. **Grow and operate**—Once the business has been carved out from the parent and has its supporting departments stabilized, the new company can start to execute its strategic growth plan. It is also necessary to clearly communicate to key stakeholders (lenders, vendors, customers, employees) that the business has changed ownership and is continuing to operate. This will help to maintain sales and business continuity.

Corporate carve-outs can be useful transactions for both the seller and acquirer. They pose some unique challenges versus acquiring entire, standalone businesses. Understanding and planning for key steps the process can increase the chance of success. ■

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Letter from AIRA's President & Executive Director

Steve Darr, CIRA, CDBV

Grant Newton, CIRA

On January 31, AIRA's Board of Directors sent a comment letter to the U.S. Trustees' office regarding proposed changes to its fee guidelines, "Reviewing Applications for Compensation and Reimbursement of Expenses Filed under USC section 330 by Attorneys in Larger Chapter 11 Cases." The content of the Board's letter appears below. In a summary of some of the 22 public comments filed with the US Trustee, Bloomberg BNA (February 15, 2011, 24 BBLR 210) noted regarding the feasibility of budgets:

> *Commentators, such as AIRA, said that it was not feasible to anticipate the path of a large Chapter11 case and, as a result, "any budget and staffing plan will be subject to continuous and significant modification as issues are identified by the professionals and other parties-in-interest." Further any modifications to the budget and/or staffing plan will require substantial effort by all parties and result in decreased efficiency and increased administrative review. AIRA quoted EQUST's White as saying in the December/January 2011 issue of the American Bankruptcy Institute's ABI Journal that "(t)he jury is out on the efficacy of budgets. Occasionally, a budget will flag a potential duplication of effort before it occurs. On balance, however, the budgeting process does not appear to impose significant billing discipline."*

January 31, 2012

Executive Office of the United States Trustee
20 Massachusetts Ave. N.W., 8th Floor
Washington, D.C., 20530

RE: Draft Guidelines for Reviewing Applications for Compensation & Reimbursement of Expenses Filed under USC § 330 by Attorneys in Larger Chapter 11 Cases

Dear Sir/Madam:

I am writing on behalf of the Association of Insolvency and Restructuring Advisors ("AIRA") to set forth our organization's comments on the above-captioned guidelines (the "Proposed Guidelines"). Thank you for this opportunity to share our thoughts and suggestions. We would be pleased to have our representatives meet with you to discuss our comments and issues.

The following comments represent the views of AIRA and not the views of any individual member of our organization.

AIRA is the leading nonprofit professional association serving financial advisors, accountants, crisis managers, business turnaround consultants, lenders, investment bankers, attorneys, trustees and others involved in the fields of business turnaround, restructuring, bankruptcy and insolvency. One of our objectives is to develop, promote and maintain professional standards of practice, as reflected by our CIRA and CDBV programs and the many regional and national conferences that we hold. It is from this perspective that we are submitting our comments.

Although the Proposed Guidelines are initially intended to apply only to attorneys in larger Chapter 11 cases, we believe that these standards may eventually apply to other professionals that are retained under §327 or §1103 of the United States Bankruptcy Code (the "Code"), such as the professionals comprising the bulk of our membership.

While we have additional comments and concerns regarding the Proposed Guidelines, we will limit our comments to the more significant issues which we feel warrant your consideration.

Our overall concern is that the Proposed Guidelines will create further inefficiencies in bankruptcy proceedings and fail to meet their stated objectives in any meaningful way.

Potential Impact of the Guidelines

The overall impact of the Proposed Guidelines may result in the selection of professionals solely or primarily on the basis of effective hourly rates. This "race to the bottom" for professional fees may effectively result in a return to the "economy of administration" standard which prevailed prior to the Code. This standard was specifically rejected in the passage of the Code; although § 330 was enacted in 1994 to curb perceived billing abuses, the economy of administration standard was not reimposed.

Comment Letter continues on p. 4

***SSO Commitments** continued from p. 3*

We are concerned that the additional disclosure and reporting requirements, especially with regard to budgets and staffing plans, will result in unnecessary disclosure of both litigation and restructuring strategies, as well as lead to substantial costs and efforts by the professional in complying with these requirements, by the US Trustee in monitoring compliance and by the Courts in addressing the many disputes that will inevitably arise. All of these factors will be to the detriment of the stated objectives of the Proposed Guidelines.

Budgets – Benchmarking the Fee Application to the Budget and Staffing Plan

The Proposed Guidelines encourage the use of budgets and staffing plans and require explanations of budget variances exceeding 10% of the amounts budgeted, as well as explanations for the appearance of any timekeeper(s) not appearing on the staffing plan.

In our experience:

- it is not feasible to anticipate the path of a large Chapter 11 case and, as a result, any budget and staffing plan will be subject to continuous and significant modification as issues are identified by the professional and other parties-in-interest;
- any modification to the budget and/or staffing plan will require reconciliations to previous budgets and explanations of variances to each party-in-interest, which will require substantial effort by all parties and result in decreased efficiency and increased administrative review;
- preparation of a meaningful budget and staffing plan may disclose confidential or otherwise privileged issues and such disclosure may not be in the best interests of the estate. These issues might include matters involving:
    - Litigation planning and strategy
    - Forensic investigations and issues
    - Lien perfection challenges/weaknesses
    - Down-sizing and employee layoff plans
    - Anticipated sale of a division or subsidiary
    - Director and Officer litigation
    - Valuation issues
    - Union contract issues
- Although budgets have been required in many cases involving fee committees or fee examiners, Clifford J. White III and Walter W. Theus, JR (Director and Trial Attorney, respectively of the Executive Office for US Trustees), in the December/January 2011 issue of the *ABI Journal*, stated that "The jury is out on the efficacy of budgets. Occasionally, a budget will flag potential duplication of effort before it occurs. On balance, however, the budgeting process does not appear to impose significant billing discipline."
- Budgets for financial advisors, accountants and other non-lawyer professional are most often reactive to legal positions and issues over which the non-lawyer professional has little or no control, including many mid-stream decisions by lawyers that have little significance on legal fee budgets but have substantial impact on financial advisory, valuation or bankruptcy accounting services and corresponding budgets (see description below).

Rates and Fee Structure

Although the Proposed Guidelines are not initially presented as applying to those who are not attorneys, we believe it appropriate to comment at this time.

Our members (other than attorneys) can be broadly referred to as Financial Advisors.

Financial Advisors are often selected in highly competitive processes known as a "beauty contest" whereby at least three potential Financial Advisors present their qualifications for the services initially contemplated, an understanding of the issues facing the Debtor and the industry in which it operates, the anticipated initial scope of the work, prior work experience and qualifications of the personnel proposed to be assigned to the engagement and the proposed rate structure. The proposed client (whether it be the Debtor, a creditors' committee or another party-in-interest) selects its professionals based on its perceptions of ability, experience and cost. Many times, alternative billing arrangements are utilized, such as reduced hourly rates with the potential for a success fee, blended hourly rate caps, monthly billing rate caps, fixed fees, etc. These competitive forces are similar to those occurring in non-bankruptcy matters and we believe that market-driven competition and review by the many parties-in-interest, including the Courts and your organization, is the best way to control professional fees in bankruptcy proceedings.

Many of the disclosures required by the Proposed Guidelines require the disclosure of:

- the highest, lowest and average hourly rate billed during the preceding 12 months for each professional and paraprofessional for estate-billed and all other matters (if applicable); and
- whether any client was charged more or less than the hourly rates included in the application.

Due to the effect of the various alternate billing arrangements described above, the billing systems of substantially all financial advisory firms do not permit the calculation of such rates as suggested by the proposed fee guidelines. This is because the effects of the alternate billing arrangements are generally applied to the overall engagement and are not available for each individual timekeeper.

Geographic Variations in Rates

The Proposed Guidelines allow "non-forum" rates where the locally prevailing rates are lower; conversely, the US Trustee will object if professionals increase their rates based on the forum where the case is pending if they bill a lower rate where they maintain their primary office.

The Proposed Guidelines are silent as to the proposed treatment of reducing "forum" rates to local rates as a result of geography or competitive pressures.

All of the national financial advisory firms operate on a national level and strive to bring the most appropriate personnel to each engagement, many of whom are from "non-forum" offices. This is more prevalent for financial advisors than for attorneys, since admission to practice requirements for financial advisors is generally not an issue. These firms have established national rates for their personnel, which may be reduced for local cases solely due to geography and other local competitive pressures, as noted above.

Any prohibition on the ability to reduce rates to serve in matters outside the professional's primary forum will result in "two-tier" organizational structures—one with professionals who serve only in the "national" cases (presumably those pending in the Districts of Delaware and the Southern District of New York) and another with professionals serving only those cases pending in the rest of the country. Such stratification of abilities and experience will deny the retention of the most qualified professionals to many clients solely on the basis of hourly rates and is not in the best interests of efficiency and judicial economy. In addition, it is likely to decrease flexibility in negotiating alternative fee arrangements in the larger Chapter 11 cases.

Recommendations

We acknowledge that, at least anecdotally, fees for all professionals in large Chapter 11 cases appear to be high. However, as shown by Professor Lubben's study, these fees need to be considered in light of the size and complexity of the cases. We suggest the following:

- Study the costs of large non-bankruptcy transactions—A successful large Chapter 11 case generally involves the transfer of the economic ownership of the Debtor to new owners. Many believe that the costs of a large Chapter11 case are consistent with and comparable to the cost structure for similar non-bankruptcy transactions involving a change in control.
    - Recommendation- Investigate and compare the costs of changes in ownership transactions, both within and outside of the bankruptcy process
- Study the benefits of adopting budgets and staffing plans—There are a sufficient number of recent large Chapter 11 cases employing the use of budgets and staffing plans to enable a determination of the benefits, if any, of employing these tools.
    - Recommendation—Commission an "event study" to determine whether or not there is a net benefit to utilizing budgets and staffing plans.
- Develop appropriate fee disclosure guidelines for financial advisors—As noted above, many financial advisory firms operate on a national level and almost all financial advisory firms employ alternate billing strategies. The internal accounting for these alternate arrangements generally make it impossible to comply with certain provisions of the proposed guidelines if they are made applicable to financial advisory services firms.
    - Recommendation—Work with our organization to accomplish your objectives while identifying and resolving the issues applicable to financial advisory firms.

As noted above, these are our primary concerns with the Proposed Guidelines. We would be more than happy to meet with you to discuss these concerns, and to assist with assessments of comments received on the Proposed Guidelines.

Very truly yours,

Grant Newton, CIRA
Executive Director

Scholar in Residence

The following guest article appears in place of the regular column by Prof. Jack F. Williams, CIRA, CDBV

Preserving Patent Licensor's SSO Commitments

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INTRODUCTION

Imagine you are the CEO of an innovative startup just starting to break through to commercial success. Along the way, your company had developed patented innovations (at least partially for defensive purposes in an industry prone to cross-licensing agreements) and helped to develop a market by working with others to create interoperable industry standards. Now, some of your former competitors (and the same companies were also former collaborators from the standards organization) are failing. The standardization effort was supposed assure reasonable and non-discriminatory terms to the participants. Now, you've heard that the "patent trolls" are circling the carcass of your coopetition! How worried should you be?

In some cases, patents are relevant to industry agreements on technology standards. Standards Setting Organizations (SSOs) usually have obligations on participants to disclose patents that they reasonably believe are essential to the implementation of the industry standards and to license those patents on Reasonable And Non Discriminatory (RAND) terms[1]. While the licensing of IP embedded in standards has always been controversial[2], based on recent reports of commercial transactions, some high profile patent portfolios can have considerable commercial value[3]. High information and transaction costs may make patent enforcement and compliance imperfect[4]. The combination of patent rights and industry agreement could give rise to significant market power, and the realignment of such power through bankruptcies could therefore be disruptive to the industry – especially if acquired by a nonpracticing entity with no need to cross-license.

The Bankruptcy Code permitting a Debtor-In-Possession (DIP) to reject patent licenses may have inequitable effects where potential licensees have inadequate notice to leverage the rights available under §365(n). Parties eligible to negotiate licenses under the RAND policies of Standards Setting Organizations (SSOs) may have inadequate notice in the event of Chapter 11 reorganization of a patent licensor obligated under these policies. This article reviews the relevant non-bankruptcy law and applicable bankruptcy law. Recent Bankruptcy Court cases and Federal Agency actions are also reviewed to develop an understanding of the challenges with the current approach before considering alternate approaches.

APPLICABLE NON-BANKRUPTCY LAW

Patents are a form of intellectual property that is granted by government for progress in the technical arts in the form of new and useful processes, machines, manufactures and compositions of matter[5]. A form of personal property, patents are assignable in writing. The USPTO provides a recordation system for the assignments and conveyances of patents[6]. Someone who makes, uses, offers to sell, or sells a patented invention in the United States, without permission of the patent holder, infringes the patent[7]. Actively inducing another party to infringe a patent also results in liability[8]. Patent infringement claims may be raised in civil suit[9] seeking remedies including injunctions[10], damages (in some cases trebled damages)[11], attorney fees[12] and customs enforcement of importation bans[13]. Patents grant rights within national law, but broadly similar patent rights are created and enforced in other countries under their national laws. Several international treaties[14] and institutions[15] have facilitated an ongoing harmonization of patent law, internationally. Recent changes[16] to the Patent Act can be seen as part of that harmonization process.

A defense to claims of infringement is absence of liability due to the existence of a license[17], however the patent statutes[18] are basically silent on the other issues related to patent licenses. Patent licenses may be express or implied[19]. Since patents provide a legal temporary monopoly over particular technical arts, guidelines[20] have been developed that restrict patent licensing practices to avoid antitrust issues. A patent license may grant rights to practice the invention on an exclusive or non-exclusive basis[21].

SSO Commitments *continues on p. 8*

1 *See e.g.*, IEEE patent policy available online at http://standards.ieee.org/develop/policies/bylaws/sect6-7.html, ANSI patent policy available online at http://publicaa.ansi.org/sites/apdl/Documents/News%20and%20Publications/Links%20Within%20Stories/ANSI%20Patent%20Policy.doc, ETSI patent policy available online at http://www.etsi.org/WebSite/AboutETSI/IPRsInETSI/IPR_Policy_FAQ.aspx, ITU-T patent policy available online at http://www.itu.int/en/ITU-T/ipr/Pages/policy.aspx

2 *See e.g.,* R. Steen, Licensing IP embodied in standards, Part 2, IEEE Micro, Sept/Oct 1999, pg 7

3 *See infra* note [87] on acquisition by Apple consortium of Nortel patent portfolio through bankruptcy

4 R.Eisenberg, Patent costs and unlicensed use of patented inventions, 78 U.Chi. L. Rev. 53, 54-55 (2011) (identifying reasons for imperfections in patent compliance and enforcement)

5 35 U.S.C. §101 (identifying eligible subject matter for patents)

6 35 U.S.C. §261 (ownership, assignment and recordation of patents)

7 35 U.S.C. §271(a) (defining patent infringement)

8 35 U.S.C. §271(b) (identifying liability from inducement of others to infringe)

9 35 U.S.C. §281 (civil remedy for patent infringement)

10 35 U.S.C. §283 (injunctive relief for patent infringement)

11 35 U.S.C. §284 (damages in patent infringement)

12 35 U.S.C. §285 (attorney fees in patent infringement)

13 19 U.S.C. §1337(d) (Tariff Act of 1930 provides for International Trade Commission to exclude infringing articles from entry)

14 *See e.g.*, General Agreement on Tariffs and Trade – Multilateral Trade Negotiations (The Uruguay Round): Agreement on Trade-Related Aspects of Intellectual Property Rights, Including Trade in Counterfeit Goods, Dec. 15, 1993, 33 I.L.M. 81 (1994) (TRIPS)

15 *See e.g.,* World Intellectual Property Organization http://www.wipo.int/portal/index.html.en

16 Leahy-Smith America Invents Act, P.L. 112-29, 125 Stat. 284-341 (Sept. 16th, 2011) (amending the US patent system to a "first to file" system to align with the majority of other national patent systems)

17 35 U.S.C. §282 (patent infringement defenses)

18 35 U.S.C. §§101-376

19 *De Forest Radio Tel. Co. v. United States,* 273 U.S. 236, 241(1927)(identifying that no formal granting of a license is necessary to give it effect)

20 United States Department of Justice, Antitrust guidelines for the licensing of Intellectual Property (1995), available online at http://www.justice.gov/atr/public/guidelines/0558.htm

21 P.Rogowski, C. Young, Ownership and Licenses in Bankruptcy and its Impact on Intellectual Property, American Bankruptcy Institute, ABI-BankIP s I.A.5 (2007)

SSO Commitments *continued from p. 7*

An exclusive license may be tantamount to an assignment and recordable at the Patent Office. A non-exclusive license is often regarded as merely a covenant not to sue, which does not affect title to the patent, and thus would not be recordable[22] .

Patents and patent licenses may be used as securities in financing arrangements. Patents and patent licenses are treated as general intangibles under Article 9 of the Uniform Commercial Code. Perfection of security interests in patents and patent licenses is generally achieved by filing the financing statement with the Office of the Secretary of State where the patent owner is deemed located, rather than the Patent Office[23]. The Patent Act provides for a recordation system at the Patent Office only for documents affecting title to a patent[24]. A security interest in a patent that does not involve a transfer of the rights of ownership is a "mere license"[25]. The Patent Act does not preempt every state commercial law that touches on intellectual property. Patent licenses are commercial agreements and the Supreme Court has observed that commercial agreements are traditionally the domain of state law[26]. Patent licenses are usually construed as a matter of State contract law[27]. In some unusual cases, there may be some grounds for disputing whether a particular commercial agreement actually constitutes a non-exclusive license[28].

APPLICABLE BANKRUPTCY LAW

A license is a contract and contracts are property of the estate[29]. While patents are considered personal property, the commercial exploitation of patents and patent licenses is largely a matter of non-individual entities, e.g., Limited Liability Companies (LLCs) or Corporations. USPTO statistics indicate individuals own less than 6% of all patents, with more than 90% owned by domestic or foreign corporations[30]. Such entities would normally be classified as "corporations" by the Bankruptcy Code[31]. Corporations as Debtors generally qualify[32] to file for bankruptcy under Chapter 7(liquidation), or Chapter 11 (reorganization). The identification and administration of the property of the estate under Chapter 5 as well as the treatment of executory contracts under Chapter 3 apply regardless of whether the bankruptcy is a Chapter 7 or Chapter 11 filing[33].

Under Chapter 11, the DIP may act as the trustee[34]; and continue to operate "in the ordinary course" of business[35]. The DIP "receives" these patent license contracts into the estate, but initially the DIP and the estate are not considered parties to such contracts and are not obligated to perform under those contracts though the automatic stay enjoins the other parties from taking certain actions against the Debtor[36]. The DIP and the estate becomes a party to the executory contract only if the DIP makes the decision to assume the responsibility for the contract[37]. While the code provides several time constraints on the actions of the DIP, the decision on whether to assume or reject executory contracts must be finalized by the date on which the reorganization plan is confirmed by the bankruptcy court[38].

The Bankruptcy Code provides that executory contracts in existence at the commencement of the case may be rejected or assumed[39]. The term "executory contract" is not defined in the Bankruptcy Code, but generally refers to contracts in which performance remains due to some extent on both sides[40]. The underperformance may need to be substantial for some courts to consider a contract executory[41]. A non-exclusive patent license is a mere waiver of the right to sue[42]. As such, the licensor owes a continuing duty to the licensee to refrain from suing it for infringement. License agreements are typically held by the courts to be executory contracts[43], though others have criticized this result as tautological[44].

22 P. Menell, Bankruptcy treatment of intellectual property assets: an economic analysis, 22 Berkeley Tech. L. J. 733, 743 (2007) (discussing Patent Act recordation system)

23 *In re Cybernetic Services, Inc.*, 252 F.3d 1039,1058 (9th Cir. 2001) (holding that a 35 U.S.C. §261 does not require the holder of a security interest in a patent to record that interest with the USPTO)

24 37 C.F.R. §3.11 (providing for recordation of documents affecting title to patents)

25 *Id.* at 1052 (construing security interests as licenses, not assignments)

26 *Aronson v. Quick Point Pencil Co.*, 440 U.S. 257, 262 (1979) (observing that state law is not displaced merely because the contract relates to intellectual property that may or may not be patentable)

27 *Lear, Inc., v. Adkins*, 395 U.S. 653, 661-62 (1969) (holding construction of a patent license was solely a matter of state law unless inconsistent with aims of federal patent policy)

28 *See e.g., Microsoft Corp. v. DAK Indus., Inc (in re DAK Indus. Inc.),* 66 F.3d 1091 (9th Cir. 1995) (holding that an agreement purporting to be a non-exclusive license was in fact a conveyance)

29 11 U.S.C. §541(a) (defining property of the estate as all legal or equitable interests of the Debtor in property as of the commencement of the case, subject to identified exceptions)

30 USPTO, Patent Technology Monitoring Team Report: Patenting by Organizations 2010: PART A1- Table A1-2b, Breakout by Ownership Category: *Percent of Patents Granted as Distributed by Year of Patent Grant*. available online at: http://www.uspto.gov/web/offices/ac/ido/oeip/taf/topo_10.htm#PartA1_2b

31 11 U.S.C. §101(9) (defining "corporation")

32 11 U.S.C. §109 (defining which classes of Debtors may file under which chapters)

33 11 U.S.C. §103 (defining applicability of chapters)

34 11 U.S.C. §1107 (defining rights powers and duties of the Debtor in possession)

35 11.U.S.C. §363(c), §1108 (indicating that the trustee may use the property of the estate and enter into transactions in the ordinary course of business)

36 P.Rogowski, C. Young, Executory Contracts in Bankruptcy and its Impact on Intellectual Property, American Bankruptcy Institute, ABI-BankIP s II.C (2007)

37 11 U.S.C. 365(a) (indicating trustee may assume or reject any executory contract)

38 11 U.S.C. 365(d)(2) (trustee may assume or reject an executory contract any time before confirmation of the plan); 11 U.S.C. 1123(b)(2) (plan may provide for assumption or rejection of executory contract)

39 11 U.S.C. 365 (a) (trustee may assume or reject executory contracts)

40 M. Primoff, E. Weinberger, E-commerce and dot-com bankruptcies: assumption, assignment and rejection of executory contracts, including intellectual property agreements, and related issues under sections 365(c), 365(e) and 365(n) of the bankruptcy code, 8 Am, Bankr. Inst. L. Rev. 307, 310 (2000) (citing definition of "executory contract" from V. Countryman, Executory Contracts in Bankruptcy: Part I, 57 Minn. L. Rev. 439, 446 (1973))

41 *In re CFLC, Inc., (formerly known as Everex Systems, Inc.) v. Cadtrak Corp.*,89 F.3d 673,677 (9th Cir. 1996)("the obligations of both parties are so far unperformed that the failure of either party to complete performance would constitute a material breach and thus excuse the performance of the other" citing *Griffel v. Murphy (In re Wegner)*, 839 F.2d 533, 536 (9th Cir.1988))

42 *De Forest Radio Tel. Co. v. United States,* 273 U.S. 236, 242 (1927) (holding patent license is covenant not to sue)

43 Primoff, note [40] *supra* at 315 (citing cases as uniformly interpreting licenses as executory contracts)

44 Menell, note [22] *supra* at 762 (criticizing that the duty from a covenant not to sue is insufficient to make a license executory, when the existence of the license is itself a complete defense to the claim)

Intellectual property laws seek to foster investment in research and development; and freedom of contract plays a significant role in the commercial exploitation of those results. Bankruptcy law affords Debtors considerable leeway to rescind contracts in reordering the affairs of a failed entity[45]. Bankruptcy law seeks to maximize the economic stake of creditors in the ongoing value of failing enterprises by reorganizing and a "fresh start"[46].

The §365 assumption or rejection of executory contracts permits the DIP to go through its inventory of executory contracts and decide which ones would be burdensome or beneficial. A beneficial executory contract may be assumed, provided any default has been cured and adequate assurance of performance is provided[47]. The DIP's decision to assume or reject an executory contract is generally approved by the court under a deferential reasonable business judgment standard[48].

If the executory contract has been assumed by the DIP, then the executory contract may be assigned to another[49]. The assignment of an executory contract to another relieves the DIP and estate from any liability for breaches occurring after the assignment[50]. If the assignee of the patent (the new licensor) is unable or unwilling to perform obligations under the license, the results could be disastrous for a licensee[51]. Non bankruptcy law may preclude the transfer of a license in some circumstances[52] (e.g., Federal law holds a nonexclusive patent license to be personal and nonassignable by the licensee[53]), but this does not restrict the patent owner (licensor) as the Debtor[54]. In assigning the executory contract, the DIP must provide adequate assurance of future performance by the assignee[55].

A burdensome executory contract may be rejected by the DIP[56]. The rejection of an executory contract constitutes a breach of that contract[57]. The time of the breach is immediately prior to the confirmation of the petition for a Chapter 11 bankruptcy[58]. A pre-petition breach of an executory contract may then result in a general unsecured claim[59].

In *Lubrizol*, the Debtor licensor was permitted to reject a technology licensing agreement resulting in a termination of the licensee's right to use the technology, leaving the licensee with only an unsecured rejection damages claim[60]. In response, Congress added §365(n) (with the 1988 Intellectual Property Bankruptcy Protection Act[61]) in order to enable the option for the licensee to continue its operation under the license . If the DIP rejects an executory contract where the Debtor is the licensor of intellectual property, the licensee now has the right to either treat this as a rejection, or to retain its rights under the license[62]. The licensee may have made substantial specific investments relying on the continued existence of the patent license[63].

If the patent license is rejected by the DIP, the licensee may retain its rights for the duration of the contract, as such rights existed immediately before the case commenced[64]. If the licensee elects to retain its rights, the licensor is required to not interfere with the licensee's rights[65]. The licensee must continue any royalty payments[66]. The DIP must provide access to the intellectual property, if presented with a written demand by the licensee[67]. The DIP is still bound by several passive obligations (e.g. adhering to confidentiality agreements)[68]. Performance of licenses requiring no action by the Debtor impose no burden on the estate and result in certainty to the economy and equity to the non-breaching party[69]. The rights retained by the licensee include the right to enforce any exclusivity portion of the contract but other rights under applicable non bankruptcy law are limited[70].

RECENT BANKRUPTCY COURT CASES

Nortel Networks Inc. was a multinational corporation operating as a major supplier of telecommunications equipment – an industry where equipment suppliers traditionally developed large patent portfolios. Nortel had also been an active participant in several industry standards organizations developing agreements to support the interoperability of their equipment with that of other manufacturers. In January 2009, Nortel filed a voluntary Chapter 11 petition for bankruptcy[71]. Nortel was a large multinational corporation, and this bankruptcy reorganization involved coordination with bankruptcy proceedings for nineteen European subsidiaries in England as well as proceedings in Canada and Israel[72]. In October 2009, Nortel, as DIP, filed an application for

SSO Commitments *continues on p. 10*

45 *Id*. at 735 (contrasting policy objectives of intellectual property and bankruptcy laws)

46 *Id*. at 751 (discussing bankruptcy system objectives)

47 11 U.S.C. §365(b) (providing for assumption of defaulted executory contracts)

48 Menell, note [22] *supra* at 767 (discussing review standard of bankruptcy court)

49 11 U.S.C. §365(f) (providing for assignment of executory contracts by first assuming them)

50 11 U.S.C. §365(k) (providing for relief from liability for trustee and estate after assignment of contracts)

51 Primoff, note [40] *supra* at 320 (discussing consequences of license assignment)

52 11 U.S.C. §365(c) (limiting assignment of executory contracts under non bankruptcy law)

53 *In re CFLC, Inc*., 89 F.3d 673, 677 (9th Cir. 1996) (holding that patent licenses are personal and nonassignable)

54 Primoff, note [40] *supra* at 324 (discussing transferability of patent licenses)

55 11 U.S.C. §365(f)(2)(B) (requiring adequate assurance of assigned executory contracts)

56 11 U.S.C. §365(a) (providing for rejection of executory contracts)

57 11 U.S.C. §365(g)(providing for rejection of executory contracts constituting breach)

58 11 U.S.C. §365(g)(1)(providing for time of breach prior to filing petition)

59 11 U.S.C. §502(g)(providing for claims arising from rejection of executory contract under §365)

60 *Lubrizol Enterprises Inc v Richmond Metal Finishers Inc.(in re Richmond Metal Finishers, Inc.*), 756 F.2d 1043,1048 (4th Cir 1985) (holding that licensee has only an unsecured pre-petition breach of contract claim for damages)

61 PL 100-506 (S 1626), Oct 18, 1988, 102 Stat 2538 (inserting new section §365 (n))

62 11 U.S.C. §365(n)(1) (providing for licensee decision when licensor rejects a patent license executory contract)

63 Menell, note [22] *supra* at 768 (discussing consequences of rescinded license)

64 11 U.S.C. §365(n)(1)(B) (providing for licensee to retain rights for the duration of the contract when licensor rejects a patent license executory contract)

65 11 U.S.C. §365(n)(2)(A) ; 11 U.S.C. §365(n)(3)(B) ; 11 U.S.C. §365(n)(4)(B) (providing that the trustee shall not interfere with the rights of the licensee)

66 11 U.S.C. §365(n)(2)(B) (providing for licensee to continue royalty payments)

67 11 U.S.C. §365(n)(3)(A); 11 U.S.C. §365(n)(4)(A) (providing that trustee is to provide access to the intellectual property on written demand by licensee)

68 Menell, note [22] *supra* at 772-73(discussing consequences of rejection of IP executory contracts and citing to *In re Szombathy*, 1996 WL 417121 at *30 (Bankr. N.D. Ill. 1996))

69 S.Rep. No. 100-505(1988) as reprinted in U.S.C.C.A.N. 3200

70 11 U.S.C. §365(n)(1)(B) (qualifying the rights retained by the licensee)

71 *In re Nortel Networks Inc.*, 2009 WL 7292466 (No1:09BK10138, Bkrtcy.D.Del) (Trial Filing) at 2

72 *Id.*

SSO Commitments *continued from p. 9*

an order authorizing employment of an independent intellectual property consultant[73]. This consultant was to evaluate both the marketability of the portfolio of 3,500 patent families and the best manner in which to maximize the value realized from this patent portfolio[74]. In phase 1 of the work, this consultant was to identify assets; perform ownership due diligence; and create an independent patent claims database; in order to perform a preliminary market analysis permitting the identification of the key markets segments covered by the patent portfolio and their relative strengths[75]. A second phase was foreseen to develop a business case for each key market segment and a third phase to develop strategic alternatives and recommend a strategy for exploiting the patent portfolio[76]. In April 2011, Nortel, as DIP, moved for an asset sale of the patents free and clear of all claims and interests[77]. The motion contemplated the sale of approximately 6,000 US and foreign patents and patent applications spanning wireless, data networking, optical, voice, internet, service provider, semiconductors and other patent portfolios[78]. Over 100 parties had been contacted about the patents, with 40 companies entering confidentiality agreements to examine diligence materials[79]. The motion contemplated a sale (for $900 Million cash - subject to higher and better bids) which envisaged transfer of the patents free and clear of all claims and interests other than those expressly assumed under the confidential Stalking Horse Agreement[80]. Unknown or unassigned licenses would be rejected under §365(a) and §365(n), and authorization for this was requested as a sound business judgment[81]. In addition to notifications to the known licensees, publication of the proposed sale was also requested as reasonable notice under the circumstances[82]. Information regarding the counter-parties under licensing arrangement was considered commercial confidential and filed under seal[83]. The license assignment and rejection procedures from the motion were adopted in the court order[84]. An objection was made by another standards participant (Microsoft Corp.) that the patents should be sold subject to all existing licensing obligations from SSOs[85]. An SSO (The Institute of Electrical and Electronics Engineers, Inc.) also filed an objection, and the successful bidder agreed to certain revisions in the patent transfer agreement[86]. The patent portfolio sale was completed for $4.5Billion in cash to a consortium of Apple, EMC, Ericsson, Microsoft, Research in Motion, and Sony[87].

Qimonda North America Corp., a Delaware corporation, was a wholly owned subsidiary marketing and selling memory chips in the United States on behalf of its parent corporation – Qimonda AG of Germany[88]. Qimonda AG filed for Bankruptcy in Germany in January 2009, and the U.S. subsidiaries filed[89] for Chapter 11 reorganization in February 2009. Qimonda's assets included approximately 10,000 patents, of which approximately 4,000 were US patents[90] of which some number are believed to read on JEDEC standards for memory chips. The foreign representative of Qimonda AG filed with the US bankruptcy court for recognition of the foreign proceedings under Chapter 15 as *In re Qimonda AG*[91]. The Bankruptcy Court issued an order[92] to that effect in July 2009, however the order was subsequently modified because of a dispute over whether 11 U.S.C. §365 applied[93]. The German insolvency code §103 conflicts with the US bankruptcy code in that the administrator may elect nonperformance ie rejecting executory contracts (in this case patent licenses) without the rights available under 11 U.S.C. §365(n) to the licensee[94]. US licensees of these patents objected, but the Bankruptcy Court ruled that the policy objectives of Chapter 15 required the proceedings to be governed by the laws where the main case was pending – in this case Germany[95]. Joint venturers and holders of patent cross-licenses appealed[96]. The District Court agreed that §365(n) was discretionary relief in the context of a chapter 15 proceeding, but remanded for further proceedings on other aspects[97]. On remand, the Bankruptcy Court held that public policy, as well as economic harm required the §365(n) protections apply to Qimonda's U.S. Patents[98].

RECENT FEDERAL AGENCY ACTIONS

The FTC has recently held hearings on inequitable behavior by patent holders in standards setting organizations[99]. This situation where the licensor of intellectual property goes bankrupt and the DIP seeks to rescind a license agreement has been identified as a point of tension between bankruptcy law and intellectual property law[100]. One of the concerns identified by some participants

SSO Commitments *continues on p. 21*

73 *In re Nortel Networks Inc.,* 2009 WL 7292466 (No1:09BK10138, Bkrtcy.D.Del) (Trial Filing)
74 *Id.* at 4
75 *Id.* at 5
76 *Id.* at 5
77 *In re Nortel Networks Inc., et al., Debtors*, 2011 WL 1227182 (Bkrtcy.D.Del) (Trial Motion, Memorandum and Affidavit) No.09-10138(KG) April 4, 2011
78 *Id.* at 3
79 *Id.* at 3
80 *Id.* at 4
81 *Id.* at 24
82 *Id.* at 24
83 *Id.* at 26
84 *In re Nortel Networks Inc., et al., Debtors*, 2011 WL 1661524 (Bkrtcy.D.Del) No.09-10138(KG) May 2, 2011 at 4
85 Limited Objection of Microsoft Corporation to Motion of Debtors to sell Certain Patents and related Assets Free and Clear of All Claims and Interests and Related Relief, *In re Nortel Networks Inc., et al., Debtors*, 2011 WL 2308621 (Bkrtcy.D.Del)(Trial Motion, Memorandum and Affidavit) No.09-10138(KG) June 13, 2011, at 3
86 S. Mills, IEEE Standards Association comments to the FTC Patent Standards Workshop Project No. P11 1204 (Aug. 5th, 2011) at 9-10, available online at http://www.ftc.gov/os/comments/patentstandardsworkshop/00046-80184.pdf
87 Nortel Completes Sale of Patents and Patent Applications, AP Alert – Business, July 29, 2011
88 Qimonda NA, Complaint for turnover of company property, declaratory judgment, injunctive relief and damages, *In re Qimonda Richmond LLC., et.al., Debtors*, 2009 WL 6364959 (Bkrtcy.D.Del)(Trial Pleading) No 109BK10589, Sept 21, 2009 at 2 (Facts #11)
89 *Id.* at 2 (Facts #15,16)
90 *In Re Qimonda AG Chapter 15, Debtor*, Case No. 09-14766-SSM, 2011 BL 278371 (Bankr. E.D. Va. Oct. 28, 2011), at 2-3
91 Qimonda, Note[88], at 2 (Facts #17); *In re Qimonda AG*, case No. 09-14766 (Bankr, E.D. Va.)
92 *Id*. at 3 (Facts #18);
93 *In re Qimonda AG*, 52 Bankr.Ct.Dec. 127, 2009 WL 4060083 No 09-14766-RGM, Nov. 19th, 2009
94 *Id.* at 1
95 *Id.* at 1,2
96 *In re Qimonda AG Bankruptcy Litigation*, 433 B.R. 547, 552 (July 2, 2010)
97 *Id.* at 571
98 *In Re Qimonda AG Chapter 15*, *Debtor*, Note [90], at 1-2
99 FTC Workshop on standards and IP.
100 Menell, note [22] *supra* at 736 (identifying principal tensions between bankruptcy law and intellectual property law)

Accounting for Reorganization Items Post Emergence

An analysis of the financial reporting requirements of ASC 852-10 "reorganizations" and current reporting by companies that have emerged from Chapter 11.

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Once an enterprise has filed a petition for bankruptcy under chapter 11 of the Bankruptcy Code, its accounting and financial reporting fall under the scope of FASB Accounting Standards Codification ("ASC") 852 *Reorganizations* ("ASC 852"). The basic concept underlying ASC 852 is for the financial statements to reflect the evolution of the entity during the bankruptcy proceeding by distinguishing transactions and events that are directly associated with the reorganization from the operations of the business. Under ASC 852, the primary method of distinguishing transactions and events associated with the reorganization, within the statement of operations, is through the use of a separate line defined as "Reorganization Items".

While the definition of Reorganization Items and the related accounting treatment for entities operating in chapter 11 is discussed in both ASC 852 and its predecessor, AICPA Statement of Position 90-7 *Financial Reporting by Entities in Reorganization Under the Bankruptcy Code* ("SOP 90-7"), the guidance within ASC 852 and SOP 90-7 does not provide clear direction on the income statement classification of direct and incremental costs related to the reorganization and restructuring of the business and incurred subsequent to emergence from bankruptcy.

This article will discuss the applicable accounting guidance and how emerging companies present those direct and incremental items related to the debtor's reorganization that are (1) incurred while the entity is in chapter 11 and (2) subsequent to its emergence from bankruptcy.

ACCOUNTING GUIDANCE

ASC 852 is the authoritative literature that must be followed by companies in chapter 11. ASC 852 indicates that the statement of operations of an enterprise in bankruptcy will reflect changes due to the evolution of the bankruptcy process. In addition, under ASC 852, items related to the bankruptcy should be presented separately in the financial statements.

ASC 852-10-45-2 states:

> For the purpose of presenting an entity's financial evolution during a Chapter 11 reorganization . . . the financial statements for periods including and after filing the Chapter 11 petition shall distinguish transactions and events that are directly associated with the reorganization from the ongoing operations of the business.

REORGANIZATION ITEMS

Judgment is required in determining items that should be reported as Reorganization Items. The glossary to ASC 852 indicates that Reorganization Items consist of items of income, expense, gain, or loss that are the result of the reorganization and restructuring of the business. Generally, only incremental costs directly related to the entity's bankruptcy filing, such as professional fees related to the reorganization and restructuring of the business, should be presented as a Reorganization Item. Recurring costs of normal operations should not be presented as reorganization items.

As contained in the predecessor to ASC 852, SOP 90-7, the task force that drafted SOP 90-7 believed that segregation of Reorganization Items provides meaningful disclosure and is consistent with APB Opinion 30, paragraph 26, which states:

> A material event or transaction that is unusual in nature or occurs infrequently but not both, and therefore does not meet both criteria for classification as an extraordinary item, should be reported as a separate component of continuing operations.[1]

ASC 852 requires companies operating under chapter 11 to report Reorganization Items as a separate line item in their statements of operations for the duration of the bankruptcy proceedings.

FINANCIAL REPORTING DURING CHAPTER 11

ASC 852 requires companies to segregate Reorganization Items from the continuing operations of the reporting entity while it is in chapter 11 and to separately account for, present and disclose Reorganization Items.

Reorganization Items represent amounts incurred (or earned) as a direct result of the reorganization of the business[2]. Examples of Reorganization Items include the following:

- Professional fees related to the reorganization
- Gains or losses and certain other adjustments to the recorded balance of debt or other payables on the basis of the measurement of the carrying amount to the amount of the allowed claim
- Losses on executory contracts rejected during the chapter 11 proceeding

***Accounting for Reorganization Items** continues on p. 12*

1 SOP 90-7, paragraph 50.
2 ASC 852-10-45-9 excludes from the definition of Reorganization Items those items that must be reported as discontinued operations in accordance with ASC 205-20 (*Presentation of Financial Statements - Discontinued Operations*) or extraordinary items in accordance with ASC 225-20 (*Income Statement - Extraordinary and Unusual Items*).

Accounting for Reorganization Items continued from p. 11

- Incremental employee costs such as special compensation arrangements to ensure the entity's ability to retain certain employees during the reorganization proceedings
- Interest income earned by an entity in bankruptcy proceedings that it would not have earned but for the proceedings

Impairment charges and restructuring activities would not usually be considered Reorganization Items because these costs are associated with the ongoing operations of the business. Only those costs initiated directly as a result of the bankruptcy filing may be presented as Reorganization Items.

Companies that are in chapter 11 are fairly consistent with how they present and disclose Reorganization Items in their statements of operations and notes to the financial statements. In most instances, Reorganization Items is presented as a single line item in the statement of operations and footnote disclosure is made to present additional information on the broad categories and provide descriptions of the types of transactions that make up the amounts of Reorganization Items.

As an example, presented below is footnote disclosure from AbitibiBowater Inc.'s Form 10-K for the year ended December 31, 2009 (in millions):

Reorganization items, net for the year ended December 31, 2009 were comprised of the following:

Professional fees	$ 106
Debtor in possession financing costs	31
Provision for repudiated or rejected executory contracts	225
Charges related to indefinite idlings and permanent closures	242
Other	35
	$ 639

FINANCIAL REPORTING AFTER EMERGENCE FROM CHAPTER 11

Subsequent to emerging from chapter 11, most companies continue to incur certain professional fees and other expenses that are directly related to the reorganization and restructuring of the business. These fees may include US Trustee fees, legal fees incurred wrapping up the chapter 11 estate, and professional fees related to the adoption of fresh start reporting.

Based on our analysis of public filings, companies do not appear to uniformly present post-emergence items related to the chapter 11 proceeding in their statements of operations. We have observed that companies generally report expenses directly related to the reorganization and incurred after emergence from chapter 11 in one of two ways:

- **Method 1:** Reorganization Items reported as a separate line item during the bankruptcy proceedings, but reported as part of operating income (typically as "Other Income/Expense") after emergence from bankruptcy. Companies using this presentation will typically disclose items related to the bankruptcy for the post-emergence period in the footnotes to their financial statements.
- **Method 2:** Reorganization Items reported as a separate line item in the statements of operations during and after emergence from bankruptcy.

Method 1 - Example

MCI, Inc. made the following disclosure regarding Reorganization Items incurred subsequent to emerging from chapter 11 in its notes to consolidated financial statements in Form 10-K for the year ended December 31, 2004.

> We continued to incur reorganization items during 2004 and will incur reorganization items in 2005 for professional fees and other bankruptcy costs, although at lower levels than in 2003. As we adopted the provisions of fresh-start reporting on December 31, 2003, for accounting purposes, reorganization expenses and changes in estimates of reorganization items previously accrued have been included in our 2004 SG&A expenses. These expenses totaled $36 million for 2004 and were primarily related to professional services related to our bankruptcy proceedings.

Other companies that have presented post-emergence Reorganization Items using the above Method 1 approach include UAL Corp (emerged from chapter 11 on February 1, 2006); Mirant Corporation (emerged from chapter 11 on January 3, 2006) and Winn Dixie Stores, Inc. (emerged from chapter 11 on November 21, 2006).

Method 2 - Example

In contrast, Dana Holding Corporation, which emerged from chapter 11 on January 31, 2008, presented the following in its form 10-K for the year ended December 31, 2010:

The reorganization items in the consolidated statement of operations consisted of the following items:

(In millions, except per share amounts)

	Dana		Prior Dana
	Year Ended December 31, 2009	Eleven Months Ended December 31, 2008	One Month Ended January 31, 2008
Professional fees	$1	$19	$27
Employee emergence bonus			47
Foreign tax costs due to reorganization			33
Interest income			(1)
Other	(3)	(3)	19
Total reorganization items	(2)	16	125
Gain on settlement of liabilities subject to compromise			(27)
Reorganization items, net	(2)	16	98

Other companies that have presented post-emergence Reorganization Items using the above Method 2 approach include Constar International, Inc. (emerged from chapter 11 on May 29, 2009); Smurfit-Stone Container Corporation (emerged from chapter 11 on June 30, 2010) and Spectrum Brands, Inc. (emerged from chapter 11 on August 28, 2009).

While as recently as five years ago, the use of the above Method 2 was infrequent, there appears to be an increasing number of companies that have opted to continue to use the Reorganization Items line in the statement of operations of the successor entity.

Accounting for Reorganization Items continues on p. 24

Piercing the Corporate Veil

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Incorporation is the bedrock of the modem business enterprise − and one way of structuring an organization so that owners and executives could be appropriately protected from the business risks associated with its operation. The corporate structure could protect the business owners and senior executive team from the risk of losing personal assets that may result as a consequence of actions by the business corporation. It allows the business to obtain financing for expansion or operations on the strength of its own balance sheet without encumbering the personal finances of the owners or the executives. And, under normal circumstances, it protects them as well from personal exposure in the event a tort or other claim results in a judgment of liability against the business enterprise.

In some instances, however, aggressive litigators may be able to reach beyond the four comers of the corporation - "piercing the corporate veil" as it is commonly known - as a means of attempting to impose liability in an underlying cause of action, such as a tort or breach of contract, directly on the personal assets of the shareholders, directors, senior executives, or dominant controlling persons. When a litigator can, to the satisfaction of the court, demonstrate that in some way the operations of the business and those of the owner or senior executives are so inextricably intertwined that they cannot be separated, then that corporate protection may dissolve, subjecting the personal assets of the shareholders or executives to exposure.

RISKS TO THE CORPORATE VEIL

It should be no surprise that during turbulent economic times, there may be increased attempts to pierce the corporate veil. This claim, if proved, could permit a court to set aside the corporate separate identity and hold an individual or corporate shareholder responsible. Research conducted in 2010 suggests that, among US corporate litigated matters, whether to pierce the corporate veil is among the most frequent issues[1]. Questions about the legitimacy of the corporate veil arise in several broad contexts. If the corporation has piled up a significant backload of unpaid bills with little hope of relief in sight, creditors' advocates may seek to recover their losses by attempting to hold shareholders or executives personally responsible for at least some of the debt. Similarly, federal or state tax collectors, faced with a significant unpaid corporate tax liability, may consider whether there is evidence to hold those same individuals responsible for covering what is owed. In either case, the attempt to pierce the veil can occur whether or not the corporation has sought to restructure its debt in bankruptcy court.

Inadequate capitalization by itself might not prompt a ruling for piercing the veil[2], but may give rise to such if it is accompanied by other circumstances, such as failure to properly protect the company for well-known risks. This is especially so when the failure to capitalize the entity points to an underlying question of bad faith on the part of the business executives. A 2005 Illinois decision is instructive. A couple who hired a contracting firm for close to $1.5 million to build their home sued the company after numerous alleged defects that culminated in failure to complete the project; the uninhabitable home was later razed. They also sued the firm's president. On paper, the president's wife was the sole shareholder of the company. However, the lower court found, and an appellate court affirmed in 2005, that the company had never been capitalized at all. The lower court judge ruled that the president of the business was "the dominant force behind this corporation, that the corporation is little more than a shell which was established to shield him from liability."[3] The president was held personally liable for the judgment.[4]

A significant tort judgment against a company - for instance from a claim of defective product manufacture or professional errors, omissions or malpractice in the case of a professional service firm - may also lead to an attempt to pierce the veil, if the circumstances lead a plaintiffs attorney to suspect that the company has wrongly sequestered assets into private hands to avoid paying just compensation. And finally and most seriously, an allegation of fraud on the part of the company, with the attendant demand for restitution, fines or both upon judicial determination, provides a strong motivation for parties to reach beyond the corporate structure and seek judicial assignment of liability directly to the individuals who own and/or operate the business.

None of these circumstances - massive debt to creditors or taxing institutions, tort liability, or fraud - by themselves may result in a judicial determination of dissolution of the protections that incorporation provides. All of them, however, have the potential of bringing the corporate veil into question, risking a judgment that owners or executives may be essentially "alter egos" of the corporation and subject to personal liability.

PRESERVING THE VEIL

Long before such a risk even presents itself, the well-managed corporation should take affirmative steps to protect its shareholders and executives from such a judgment by putting into place the necessary safeguards to ensure the appropriate separation between the organization and the individuals who own

***Piercing the Corporate Veil** continues on p. 14*

1 McPherson, Richmond & Raja, Nader (2010), "Corporate Justice: An Empirical Study of Piercing Rates and Factors Courts Consider When Piercing the Corporate Veil", Wake Forest Law Review 45: 931-969.

McPherson & Raja quote, and follow up on the research reported in what they identify as "the foundational empirical study" on the subject of corporate-veil piercing. That study is:

Thompson, Robert B. (1991), "Piercing the Corporate Veil: An Empirical Study", Cornell Law Review 76: 1036-1074

2 McPherson, Richmond & Raja, Nader (2010), "Corporate Justice: An Empirical Study of Piercing Rates and Factors Courts Consider When Piercing the Corporate Veil", Wake Forest Law Review 45: 931-969. p. 963

3 Fontana v. TLD Builders, No. 01-MR-745, (Circuit Court of Du Page County, Ill., 2001), aff'd., 2-05-0045 (Ill2d App.2005).

http://www.state.il.us/courtlopinionslappellatecourtl2005/2nddistrictldecemberlhtm1l2050045.htm

4 Fontana v. TLD Builders, No. 01-MR-745, (Circuit Court of Du Page County, Ill., 2001), aff'd., 2-05-0045 (Ill 2d App. 2005).

http://www.state.il.us/courtlopinions/appellatecourtl2005/2nddistrictldecember/htm1l2050045.htm

Piercing the Corporate Veil continued from p. 13

and operate it. Those safeguards include structural, financial, and operational measures. Corporations seeking to maintain that distinction should seek legal and accounting advice to set up systems and controls to establish and document the following:

Follow corporate formalities—Even the smallest corporation must adhere to the responsibilities imposed by the state laws where the firm is incorporated. Legal expertise should be consulted to ensure that the business is abiding by those strictures. The requirements may vary from state to state, but in general, they include:

- Maintaining an active board of directors;
- Documenting and maintaining the board of directors minutes with corporate resolutions properly authorized and noted;
- Ensuring active, functioning, and responsible officers;
- Consistently filing all required state paperwork associated with being incorporated, such as the original registration, subsequent renewals, and any amendments to the Articles of Incorporation;
- Issuing stock that is duly authorized, and keeping track of stock issuances;
- Producing an annual report and holding an annual meeting, complete with accurate minutes and documented votes.

Maintain separate finances and appropriate financial controls—First, a functioning corporation, whether it is a longstanding organization that has passed through several generations of leadership or a brand-new startup launched by an ambitious entrepreneur, must be adequately capitalized with an appropriate initial investment, reasonable reserves to ensure on-time payment to creditors, and resources to cover its basic needs, from insurance to raw materials to human capital.

Second, the financial structure of the corporation must be independent from the finances of the owner. Separate cash, bank and credit accounts in the name of the corporation must be maintained. Personal funds and corporate funds must not be commingled. Payments from the corporation to the owner should be made in accordance with a formal structure, in the form of wages, salary or dividends, and should be governed by a formal employment agreement between the corporation and the individual acting as an executive, duly authorized by the board of directors or its designee. Financing arrangements and covenants should be documented and reviewed periodically for compliance with lenders' requirements.

Unauthorized payouts to shareholders or other stakeholders whether reported in the accounting records or not, would give rise to attempts by disgruntled parties to attempt to pierce the corporate veil. So would paying personal expenses from corporate accounts or moving money back and forth between the personal and corporate accounts. Corporate accounts must not take on the appearance of being simply a personal piggy bank on which a stakeholder could draw. Accordingly, the establishment of, and compliance with, formalized corporate expense and reimbursement policies is crucial.

Accompanying a true separate financial structure for the business should be the full complement of financial controls and procedures governing how corporate funds are invested, saved, and disbursed, as well as how and when the corporation goes into debt in the course of its operation. These controls include procedures to ensure that financial decisions are subject to thorough internal scrutiny and properly authorized supported by relevant documentation. In addition, regular audits along with appropriate internal control procedures governing purchasing of supplies and capital equipment, the hiring and termination of employees, as well as the selection of vendors and professional consultants to the business, are all part of that strong financial control regime.

Maintain an ethical workplace—This means don't merely avoid fraud, but put in place ethical principles to which all must subscribe as a condition of employment and follow through on their terms and conditions. A detailed ethics policy should address risks of misconduct specific to the organization and establish a positive and ethical "tone at the top" that encourages flows of communication from all levels. Institution of a "hot line" for confidential reporting of allegations of wrongdoing is a must. Organizations should establish a code of conduct for all employees and regularly seek employees' certification that they have reviewed the document. Documentation of the reviews should be maintained. The organization would be wise to create an atmosphere of intolerance of unethical behavior. Corporate funds should never be used to engage in illegal, fraudulent or reckless acts.

CONCLUSION

The limited liability afforded by business incorporation is a valuable asset to both the business itself and the principals who own and operate it. However, that limited liability protection is not certain. It can best be sustained by structuring and operating the business so that it remains a truly separate entity at arm's length from those individuals running it, in fact as well as on paper.

While there is no guarantee of protection from a veil-piercing action, taking the steps outlined above can help ensure that the organization as well as its principals will remain reasonably safe from such a successful action. ■

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Bankruptcy Taxes

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ADVISER'S TOOLKIT: LITTLE KNOWN TECHNIQUE—THE PARTIAL CORPORATE LIQUIDATION

A little known technique for achieving capital gain treatment is available for situations in which a corporation sells or liquidates one business but continues to operate one or more other businesses. In a qualifying partial liquidation, distributions of cash or assets from the liquidated operation qualify for capital gain treatment to noncorporate shareholders, i.e. individuals, trusts and partnerships. The alternative treatment of such distributions is dividend treatment. While both dividends and capital gains are currently taxed at the same 15% rate to individual shareholders, there are several important advantages of capital gain treatment over dividend treatment:

1. Where the distribution is characterized as a capital gain, the recipient is allowed to allocate stock basis against the gross proceeds received, thereby reducing the taxable gain recognized.
2. Capital gains can be reduced by capital losses including capital loss carryforwards. Many individuals still have substantial capital loss carryforwards from the financial meltdown of a few years ago.

A distribution qualifies as a "partial liquidation" if it meets the tests below, is pursuant to a plan of liquidation, and occurs within the tax year in which the plan is adopted or within the succeeding tax year. (Code Sec. 302(e)). If a distribution qualifies, it does not have to be pro rata among shareholders, i.e. can be disproportionate.

A distribution will qualify if the following conditions are met:

(1) The distribution must be attributable to the cessation by the distributing corporation of the conduct of a trade or business that was actively carried on, for a period of five years preceding the date of redemption. The distribution may take the form of the cash proceeds or installment receivables from the sale of the discontinued assets of the business, of the current assets of that business, or a combination of assets and sale proceeds.

(2) Immediately after the distribution, the distributing corporation must be actively engaged in conducting another trade or business that also had been carried on for at least five years.

Example 1

Corporation X has operated a restaurant division and a wholesale foods distribution business for over 5 years each. The board of directors decides to get out of the restaurant business, adopts a plan of partial liquidation and sells the restaurant operation for $20 million. Corporation X had basis in the assets sold of $18 million, so it pays corporate income tax of $700,000 ($2,000,000 × 35%). The corporation then distributes the net cash proceeds of $19.3 million ($20 million - $700,000) pro rata to its shareholders and no actual surrender of shares by shareholders is required. Shareholder A held X stock with a market value of $50,000 and basis of $22,000 and received cash proceeds from the partial liquidation of $25,000. Thus the partial liquidation amounted to 50% of the value of A's stock. A calculates his gain as $25,000 - $11,000 (50% × basis $22,000) = $14,000. A also had a capital loss carryover of $5,000. A will pay individual income tax on a gain of $9,000 ($14,000 - $5,000).

Example 2

The facts are the same as in Example 1 except that Corporation X has owned the restaurant operation only four years so that it does not qualify for partial liquidation treatment. The corporate level tax on the sale is the same as in Example 1 but the distribution constitutes just a large dividend to the shareholders. Individual A will pay tax on the entire $25,000 dividend he receives with no reduction for basis or capital losses.

Conclusion

Under today's tax rules in which dividends and capital gains are both taxed at 15% to individual shareholders, in some transactions the distributing corporation does not bother to try to meet the relatively narrow partial liquidation criteria. However, if the tax rate on dividends received by individuals is increased, more transactions will be structured as a partial liquidation.

TAXPAYER FAVORABLE RULING MAKES IMPORTANT DISTINCTION IN BAPCPA TAX DISCHARGEABILITY

In a recent bankruptcy court decision, the judge ruled that a prior dismissed Ch. 13 case did not toll (or suspend) the running of the statute of limitations on personal income taxes for the years in question resulting in discharge of the taxes. While this case involved a previously dismissed Ch. 13 case and a current Ch. 7 case of an individual, the same principle may apply with other types of bankruptcy cases and is one of the first cases to construe this aspect of the tolling provisions enacted in BAPCPA 2005. The facts in the case are a little tangled so you have to pay close attention to the dates of the petitions and the due dates of the taxes involved to catch the distinction the court is making. In re Kolve, U.S. Bankruptcy Court, W.D. Wisconsin; 10-18348-7, September 22, 2011.

Excerpts from the court decision

The debtors, Duane and Angela Kolve, filed a Ch. 7 petition on November 12, 2010. They had previously filed a chapter 13 case in October of 2005. Their plan in that case was confirmed in February of 2006. Unfortunately, the case was subsequently dismissed in October of 2007 prior to the completion of the plan payments (presumably due to the debtors' nonperformance). The debtors concede that they still owe individual income taxes for 2005, 2006, and 2007, as well as so-called "trust fund" taxes. The debtors acknowledge that the trust fund taxes and the 2007 income taxes are nondischargeable. However, they seek to discharge the income taxes for 2005 and 2006. Those claims amount to approximately $61,000.00.

Bankruptcy Taxes *continues on p. 16*

Bankruptcy Taxes *continued from p. 15*

The bankruptcy code provides that taxes which are afforded priority status under § 507(a)(8) are nondischargeable in a chapter 7 case. As a result, a chapter 7 debtor cannot discharge tax liabilities owed in connection with a tax return that was due within three years of the bankruptcy petition, typically referred to as the "three-year lookback period." The provision "encourages" the IRS to take action, whether it be to collect the debt or perfect a tax lien, and if the government sleeps on those rights, they are lost.

Because the debtors initially requested extensions of time to file both their 2005 and 2006 personal income tax returns, those returns were due on October 15, 2006, and October 15, 2007, respectively. The lookback period of 507(a)(8)(A)(i) is defined by the filing of "the" petition, which in this case occurred in November of 2010. Even taking into account the requested extensions, the 2005 and 2006 returns were due more than three years before the filing date; as such, the debtors contend that the tax claims are dischargeable. The IRS disagreed arguing that the debtors' prior chapter 13 case operates to "toll" or suspend the lookback period and preclude the discharge of all the taxes in this case.

The essential point of disagreement is the application of an unnumbered tolling provision found at the end of § 507(a)(8):

> *An otherwise applicable time period* specified in this paragraph *shall be suspended for* any period during which a governmental unit is prohibited under applicable nonbankruptcy law from collecting a tax as a result of a request by the debtor for a hearing and an appeal of any collection action taken or proposed against the debtor, plus 90 days; *plus any time during which the stay of proceedings was in effect in a prior case under this title* or during which collection was precluded by the existence of one or more confirmed plans under this title, plus 90 days (emphasis added).

The IRS believes that under this tolling provision, the lookback period must be extended because the taxes came due during the pendency of the prior case. Specifically, the IRS contends that the lookback period for the 2005 taxes should be tolled for 459 days (for the period from October 15, 2006, until the dismissal of the case, plus 90 days), while the lookback period for the 2006 taxes should be tolled for 94 days. According to the IRS, this means that the three-year lookback period begins on January 17, 2008, and this case was filed within three years of that date, rendering the taxes nondischargeable.

The debtors do not appear to take issue with these calculations per se. However, they dispute the applicability of the tolling provision itself. The debtors read the statute as authorizing tolling only if the automatic stay was in fact in effect as to a particular claim. The debtors argue that because the taxes came due after the filing of the prior case, the automatic stay did not preclude the IRS from attempting to collect the taxes. In this regard, they note that § 362(a)(8) only prohibits the commencement or continuation of a proceeding for taxes "for a taxable period ending before the date of the order for relief."

The statute incorporates the notion inherent in the concept of equitable tolling: namely, that the government was in fact impeded in some fashion by prior events. If the government is prohibited from collecting because of a request by the debtor for a hearing, or because the debtor appealed a collection action, the lookback period is extended. Likewise, if collection was precluded by a confirmed plan, the lookback period is extended. But if the relevant portion of the statute is read as the IRS wishes, the government conceivably also gains an extension of the lookback period even when it suffered no "disability" in its collection activities at all. Such a result hardly seems consistent with the typical basis for establishing a limitations period (i.e., the idea that a creditor is thus "encouraged" to take action on its claim), or with the equitable basis for tolling such periods (namely, the concern that the creditor was actively prevented from taking the actions otherwise encouraged by the limitations period).

The debtors' chapter 13 plan was confirmed in February of 2006. The plan does not appear to have contained any provision which would prohibit the collection of these tax claims. The confirmation returned control over all pre-confirmation property of the estate to the debtors, and at least some post-confirmation property as well. This revesting meant that the automatic stay - which had previously acted to prevent post-petition creditors from pursuing property of the estate - was no longer "in effect" as to those assets. The stay never prohibited the IRS from pursuing a collection action against the debtors, and at the time these tax claims came due, the "stay of proceedings" was in effect (at most) as to only a portion of the debtors' post-confirmation assets.

As the IRS did not in fact suffer under any such disability, and could instead have acted to collect the post-confirmation taxes at any time after they came due from those assets which had revested in the debtor upon confirmation under § 1327, there is no basis for tolling, whether pursuant to the statute or in equity."

Commentary

The point the court is making is that in the common situation where a petitioner files successive petitions in bankruptcy, you have to look carefully at the due dates of the tax returns involved. If the due date of a return falls after the first petition date and more than three years before the second petition, the tax may be dischargeable. I suppose the unusual fact is that the debtor had assets in the interim which IRS at least theoretically could proceed against as the court ruled in the Ch. 13 case. But I presume this can also happen in a Ch. 11 case, so the decision may have wider application. It also remains to be seen if higher courts follow this line of reasoning.

OFT DELAYED GOVERNMENT CONTRACTOR 3% WITHHOLDING REPEALED

Repeal of withholding

The Tax Increase Prevention and Reconciliation Act of 2005 contained a three-percent withholding requirement for contractors doing business with Federal, State and local government agencies. The provision generated considerable concern among taxpayers and the effective date was postponed several times. While the provision was intended to improve tax compliance, it was highly criticized as having the effect of reducing the cash flow of many cash-strapped employers and requiring significant outlays to modify payment systems by governmental entities, which would outweigh any potential improvement in tax compliance. Under a new federal law, Public Law 112-56, the withholding provision is repealed as if it had never been enacted.

Continous levy

Under Code Sec. 6331(h), the IRS is authorized to continuously levy specified payments made to, or received by, delinquent taxpayers. The new Act amends the Internal Revenue Code to extend the 100% continuing levy for delinquent taxes to payments due to a vendor of property (currently, goods or services) sold or leased to the federal government, including real property.

Still seeking other collection measures

The Act directs the Secretary of the Treasury, in consultation with the Director of the Office of Management and Budget and federal agency heads, to conduct and report on a study on ways to reduce the amount of federal tax owed but not paid by persons submitting bids or proposals for the procurement of property or services by the federal government. The Treasury Department will estimate the amount of delinquent taxes owed by federal contractors, the success of the federal lien and levy program in recovering delinquent taxes, and more. ■

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Bankruptcy Cases

Professor Baxter Dunaway

BANKRUPTCY

Fifth Circuit

Does judicial estoppel bar a blameless bankruptcy trustee from pursuing a judgment that the debtor—having concealed the judgment during bankruptcy—is himself estopped from pursuing?

The question before the en banc court was whether judicial estoppel bars a blameless bankruptcy trustee from pursuing a judgment that the debtor—having concealed the judgment during bankruptcy—is himself estopped from pursuing. The court held that it does not. This result upholds the purpose of judicial estoppel, which in this context is to protect the integrity of the bankruptcy process, by adhering to basic tenets of bankruptcy law and by preserving the assets of the bankruptcy estate for equitable distribution to the estate's innocent creditors. *Reed v. City of Arlington*, 650 F.3d 571, 55 Bankr.Ct.Dec. 68, Bankr. L. Rep. P 82,051(5th Cir.(Tex.) Aug 11, 2011) (NO. 08-11098).

Seventh Circuit

To set aside as preferential transfers, is a member or manager of a LLC a statutory insider?

Chapter 11 trustee brought adversary proceeding to set aside, as preferential transfers, prepetition payments that debtor-limited liability company (LLC) made to one of its managing members. The United States Bankruptcy Court for the Northern District of Illinois entered judgment in trustee's favor with respect to payment that had been made more than 90 days, but less than one year, prepetition. Member appealed. The United States District Court for the Northern District of Illinois, 431 B.R. 193, affirmed. Member appealed. The Court of Appeals held that member or manager of LLC was statutory insider. Affirmed. *In re Longview Aluminum, L.L.C.*, No. 10-2780, 2011 WL 3966152 (7th Cir. Sept. 2, 2011).

Pursuant to 11 U.S.C. § 547(b), a bankruptcy trustee is able to avoid certain transfers made by a debtor prior to filing for bankruptcy. Generally, all transfers within 90 days of the debtor's bankruptcy filing are considered preferential and subject to avoidance. 11 U.S.C. § 547(b)(4)(A). When the creditor is an "insider" of the debtor, however, the Bankruptcy Code enlarges the time period for avoidance to one year before the bankruptcy filing. 11 U.S.C. § 547(b)(4)(B). The Bankruptcy Code defines an insider of a corporation as a: (i) director of the debtor; (ii) officer of the debtor; (iii) person in control of the debtor; (iv) partnership in which the debtor is a general partner; (v) general partner of the debtor; or (vi) relative of a general partner, director, officer, or person in control of the debtor. 11 U.S.C. § 101(31)(B). Courts regularly treat this definition as illustrative of types of insider relationships and not as an exhaustive list. *In re Longview Aluminum, L.L.C.*, No. 10-2780, 2011 WL 3966152 (7th Cir. Sept. 2, 2011).

The insider analysis is a case-by-case decision based on the totality of the circumstances, and bankruptcy courts have used a variety of factors in their determinations. One approach focuses on the similarity of the alleged insider's position to the enumerated statutory categories, while another approach focuses on the

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alleged insider's control of the debtor. If the alleged insider holds a position substantially similar to the position specified in the definition, a court will often find that individual to be an insider. But, based on the legislative history of the statute, case law has also held that the term insider can also encompass anyone with a "sufficiently close relationship with the debtor that his conduct is made subject to closer scrutiny than those dealing at arm's length with the debtor." Matter of Krehl, 86 F.3d 737 C.A.7 (Wis.),1996. *Id*. at 741–42 (citing S.Rep. No. 989, 95th Cong.2d Sess., *reprinted in* 1978 U.S.C.C.A.N. 5787, 5810). For this second approach, courts look to the closeness of the relationship between the parties. *In re Longview Aluminum, L.L.C.*, No. 10-2780, 2011 WL 3966152 (7th Cir. Sept. 2, 2011).

The district court looked to both Delaware corporate and LLC law to properly analogize a director of a corporation to a member of an LLC. Under Delaware law, a corporation must "be managed by or under the direction of a board of directors...." 8 Del. C. § 141(a). With respect to an LLC, Delaware law states that "[u]nless otherwise provided in a limited liability company agreement, the management of a limited liability company shall be vested in its members...." 6 Del. C. § 18–402. The district court concluded that directors generally have the authority to manage a corporation and members generally have the authority to manage an LLC, and thus found a member analogous to a director.

Seventh Circuit

Is a bankruptcy court's order remanding removed claims to state court based upon lack of subject matter jurisdiction appealable?

In *Townsquare Media, Inc. v. Brill*, No. 10-3017, 2011 WL 2906162 (7th Cir. July 21, 2011) the court held that pursuant to 28 U.S.C.A. § 1447(d), a bankruptcy court's order remanding removed claims to state court based upon lack of subject matter jurisdiction is nonappealable. Bankruptcy court's remand of action removed from state court was not reviewable by Court of Appeals where remand was on ground of lack of subject-matter jurisdiction, rather than relinquishment of supplemental jurisdiction, even if bankruptcy court erroneously determined that it lacked subject-matter jurisdiction after plaintiff amended complaint to remove claims that challenged bankruptcy court's confirmation of liquidation plan. See 28 U.S.C.A. §§ 1367(a), 1441(a), 1447(d), 1452(b) and *Bankruptcy Court's Remand Was Not Reviewable*, 08-10-11 West's Bankruptcy Newsletter 5 (2011).

Eighth Circuit BAP

1. Can a Chapter 13 debtor strip off a wholly unsecured lien on his principal residence, without violating anti-modification provision, and 2. Is a strip off of a wholly unsecured lien on Chapter 13 debtor's principal residence effective upon completion of debtor's obligations under his plan, and is not contingent on debtor's receipt of Chapter 13 discharge?

The Eighth Circuit Bankruptcy Appellate Panel, Schermer, J., held that: 1. Chapter 13 debtor may generally strip off a wholly unsecured lien on his principal residence, without violating antimodification provision, and 2. strip off of a wholly unsecured lien on Chapter 13 debtor's principal residence is effective upon completion of debtor's obligations under his plan, and is not contingent on debtor's receipt of Chapter 13 discharge. Reversed and remanded. *In re Fisette*, 2011 WL 3795138, 455 B.R. 177 (B.A.P. 8th Cir. 2011).

I. Strip Off of Wholly Unsecured Liens

A determination of whether the Bankruptcy Code allows the "strip off" of the junior liens on the Debtor's principal residence if they are wholly unsecured involves the interaction of two provisions of the Bankruptcy Code—§ 506(a) and § 1322(b)(2).

Bankruptcy Code § 506(a) governs classification of a claim. It provides, in pertinent part, that:

> An allowed claim of a creditor secured by a lien on property in which the estate has an interest, ..., is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, ..., and is an unsecured claim to the extent that the value of such creditor's interest ... is less than the amount of such allowed claim.
>
> 11 U.S.C. § 506(a).

With an exception, a Chapter 13 debtor may modify the rights of creditors, such as by avoiding their liens, through his plan. Section 1322(b)(2) of the Bankruptcy Code permits a Chapter 13 plan to "modify the rights of holders of secured claims, other than a claim secured only by a security interest in real property that is the debtor's principal residence, or of holders of unsecured claims...." 11 U.S.C. § 1322(b)(2).

In *Nobelman v. Am. Sav. Bank*, 508 U.S. 324, 113 S.Ct. 2106, 124 L.Ed.2d 228 (1993), the Supreme Court examined the relationship between § 1322(b)(2) and § 506(a) with respect to an undersecured lienholder. *Bartee v. Tara Colony Homeowners Ass'n (In re Bartee)*, 212 F.3d 277, 285 (5th Cir.2000) (citing *Nobelman*, 508 U.S. 324, 113 S.Ct. 2106). It held that the debtor could not "strip down" the unsecured portion of the creditor's undersecured claim on the debtor's principal residence. *Nobelman*, 508 U.S. at 332, 113 S.Ct. 2106. The Court rejected the debtors' argument that § 1322(b)(2)'s anti-modification clause should apply only to the secured portion of the claim, and not to the unsecured portions of the undersecured claim. *Id*. at 328–332, 113 S.Ct. 2106. The phrase "claim secured only by a security interest in real property that is the debtor's principal residence" in § 1322(b)(2) included both the secured and the unsecured portion of the Nobelman creditor's undersecured claim. *Id*. at 330–31, 113 S.Ct. 2106. The Court explained that the debtors could not modify the payment and interest terms for the unsecured portion of the claim without modifying the rights of the creditor with respect to the secured portion of the claim, thus violating § 1322(b)(2). *Id*. at 331, 113 S.Ct. 2106. "The decision in Nobelman then stands for the proposition that the anti-modification clause of § 1322(b)(2) bars Chapter 13 debtors from stripping down a debtor's claim *when any portion of that claim is secured by the debtor's home.*" *Griffey v. U.S. Bank (In re Griffey)*, 335 B.R. 166, 168–69 (10th Cir. BAP 2005) (emphasis added).

Before and after *Nobelman*, bankruptcy courts in Minnesota have held that a debtor may not strip off a wholly unsecured lien on his principal residence without violating the provisions of § 1322(b)(2). See, e.g., *In re Frame*, No. 09–41010 (Bankr.D.Minn. September

23, 2009); *In re Hughes*, 402 B.R. 325, 326 (Bankr.D.Minn.2009); *In re Hussman*, 133 B.R. 490, 491–93 (Bankr.D.Minn.1991). Overall, these courts interpret § 1322(b)(2) to mean that a debtor cannot modify the rights of any creditor with a "claim secured only by a security interest in real property that is the debtor's principal residence." They believe that the type of the claimant is controlling, and that determination of the secured status of the claim under § 506(a) is irrelevant when applying § 1322(b)(2)'s antimodification clause. The BAP court in *Fisette* disagree with these cases. *In re Fisette*, 2011 WL 3795138, 455 B.R. 177, 182 (B.A.P. 8th Cir. 2011).

The BAP court in *Fisette* agrees with the majority of courts that hold that § 1322(b)(2) does not bar a Chapter 13 debtor from stripping off a wholly unsecured lien on his principal residence, a position that has been adopted by all Circuit Courts of Appeal to address this issue. See, e.g., *Zimmer v. PSB Lending Corp. (In re Zimmer)*, 313 F.3d 1220 (9th Cir.2002); *Lane v. W. Interstate Bancorp (In re Lane)*, 280 F.3d 663 (6th Cir.2002); Pond, 252 F.3d at 127; *Tanner v. FirstPlus Fin., Inc. (In re Tanner)*, 217 F.3d 1357 (11th Cir.2000); *In re Bartee,* 212 F.3d 277 (5th Cir.2000); *McDonald v. Master Fin. Inc. (In re McDonald),* 205 F.3d 606 (3d Cir.2000). Bankruptcy appellate panels of the Tenth and First Circuits have agreed with this conclusion. *Griffey*, 335 B.R. 166; *In re Mann*, 249 B.R. 831 (1st Cir. BAP 2000).In *Lane*, the Sixth Circuit Court of Appeals[1] provided a helpful summary of the majority position the BAP followed in *Fisette*:

The message, to recapitulate, is this:

> — Section 1322(b)(2) prohibits modification of the rights of a holder of a secured claim if the security consists of a lien on the debtor's principal residence;— Section 1322(b)(2) permits modification of the rights of an unsecured claimholder;— Whether a lien claimant is the holder of a "secured claim" or an "unsecured claim" depends, thanks to § 506(a), on whether the claimant's security interest has any actual "value;" — If a claimant's lien on the debtor's homestead has a positive value, no matter how small in relation to the total claim, the claimant holds a "secured claim" and the claimant's contractual rights under the loan documents are not subject to modification by the Chapter 13 plan;— If a claimant's lien on the debtor's homestead has no value at all, on the other hand, the claimant holds an "unsecured claim" and the claimant's contractual rights are subject to modification by the plan.
>
> *Lane*, 280 F.3d at 669.

II. Strip Off Where Debtor Is Ineligible for a Discharge Under 11 U.S.C. § 1328(f)(1)

When a debtor obtains a Chapter 7 discharge and files a Chapter 13 case in such close proximity to his Chapter 7 case that he is ineligible for a Chapter 13 discharge under § 1328(f)(1), the situation is commonly referred to as a "Chapter 20." A Chapter 7 debtor's discharge, standing alone, does not deprive a mortgagee of its right to collect its debt in rem. 11 U.S.C. § 524(a)(2) ("A discharge ... operates as an injunction against the commencement or continuation of an action, the employment of process, or an act, to collect, recover or offset any such debt as a personal liability of the debtor") (emphasis added); *Johnson v. Home State Bank*, 501 U.S. 78, 84, 111 S.Ct. 2150, 115 L.Ed.2d 66 (1991) Courts disagree regarding whether a debtor's ineligibility for a discharge bars him from using § 1322(b)(2) to permanently strip off an otherwise wholly unsecured lien on his principal residence. Some courts say that a debtor's eligibility for a discharge is not a requirement for lien avoidance. *See, e.g., Jennings*, 454 B.R. 252 (Bankr.N.D.Ga.2011); *Okosisi*, 451 B.R. 90; *Fair*, 450 B.R. 853 (E.D.Wis.2011); *In re Waterman*, 447 B.R. 324 (Bankr.D.Colo.2011); *In re Tran*, 431 B.R. 230 (Bankr.N.D.Cal.2010); *In re Hill*, 440 B.R. 176 (Bankr.S.D.Cal.2010). Other courts say that a debtor cannot permanently strip off a lien on his principal residence if he is ineligible for a discharge. *See, e.g., In re Victorio*, 454 B.R. 759 (Bankr.S.D.Cal.2011); *In re Gerardin*, 447 B.R. 342 (Bankr.S.D.Fla.2011); *In re Fenn*, 428 B.R. 494 (Bankr.N.D.Ill.2010); *In re Mendoza*, No. 09–22395 HRT, 2010 WL 736834 (Bankr.D.Col. Jan. 21, 2010); *In re Jarvis*, 390 B.R. 600, 604–06 (Bankr.C.D.Ill.2008). The BAP in *Fisette* held that the strip off of a wholly unsecured lien on a debtor's principal residence is effective upon completion of the debtor's obligations under his plan, and it is not contingent on his receipt of a Chapter 13 discharge. Allowing a strip off of wholly unsecured junior liens, on real property which was debtor's principal residence, in a no-discharge "Chapter 20" case would not be tantamount to allowing debtor a "de facto" discharge, in violation of Bankruptcy Code provision limiting debtor's right to a Chapter 13 discharge following grant of earlier discharge in Chapter 7. 11 U.S.C.A. § 1328(f).

Seventh Circuit

Did debtor's former shareholder commit "fraud on the court" when he signed an involuntary petition?

Seventh Circuit held that debtor's former shareholder did not commit "fraud on the court "when he signed an involuntary petition. A creditor who makes false representations or encourages others to do so is different than a lying witness, and a witness's lies are not fraud on the court unless a lawyer in the case is complicit in them. Former shareholder signing involuntary petition is in the position of a witness, and although in this case he is a lawyer he was serving as a party, not a lawyer, when he signed the petition. Fraud is not a basis to rescind a bankruptcy sale when there is no proof that the purchaser was a party to any alleged fraud. *In re Golf* 255, Inc., No. 10-3732, 652 F.3d 806 2011 WL 3104058 (7th Cir. July 22, 2011).[2]

The term "fraud on the court" is not defined in Rule 60 or elsewhere in the federal rules, and the definition most often offered by the courts that it consists of acts that "defile the court," e.g., Drobny v. Commissioner, 113 F.3d 670, 677–78 (7th Cir.1997); 12 Moore's Federal Practice § 60.21[4], p. 60–56 and n. 20 (3d ed.2011)—though vivid, doesn't advance the ball very far. Drobny's full definition advances it a little farther: " 'that species of fraud which does, or attempts to, defile the court itself, or is a fraud perpetrated by officers of the court [i.e., lawyers] so that the judicial machinery cannot perform in the usual manner its impartial task of adjudging cases.' " 113 F.3d at 677–78 .

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1 *Lane v. W. Interstate Bancorp (In re Lane)*, 280 F.3d 663 (6th Cir.2002).

2 2011 No. 9 Norton Bankr. L. Adviser 4.

Bankruptcy Cases *continued from p. 19*

Tenth Circuit

Does Bankruptcy Appellate Panel Bankruptcy Appellate Panel lack jurisdiction over post-transfer order issued outside judicial district where appeal was filed?

The Court of Appeals, held in a matter of first impression that BAP lacked jurisdiction over post-transfer order issued outside judicial district where appeal was filed. *HealthTrio, Inc. v. Centennial River Corp. (In re HealthTrio, Inc.*), No. 10-1351, 2011 WL 3373798 (10th Cir. Aug. 5, 2011).

The primary issue in this Chapter 7 bankruptcy case is whether the United States Bankruptcy Appellate Panel of the Tenth Circuit (BAP) had jurisdiction to review an "order for relief" entered by a bankruptcy judge serving in the United States Bankruptcy Court for the District of Delaware (Delaware Bankruptcy Court). The Delaware bankruptcy judge entered the order for relief after the effective date of a transfer of venue he had ordered under 28 U.S.C. § 1412 to the United States Bankruptcy Court for the District of Colorado (Colorado Bankruptcy Court). The parties agree that the order should be vacated on the ground that it is void because it was issued after the transfer was complete and therefore in the absence of jurisdiction, a proposition that finds footing in the case law of both the Third and Tenth Circuits. *See Hudson United Bank v. Chase Manhattan Bank of Conn., N.A.,* 43 F.3d 843, 845 n. 4 (3d Cir.1994) (explaining that transferor court loses jurisdiction once transfer is complete, which occurs "when the files in a case are physically transferred to the transferee court"); *Chrysler Credit Corp. v. Country Chrysler, Inc.*, 928 F.2d 1509, 1516–17, 1520 (10th Cir.1991) (same); see also *Cunningham v. BHP Petroleum Gr. Brit. PLC*, 427 F.3d 1238, 1245 (10th Cir.2005) (stating that judgment is void if court lacked subject matter jurisdiction); *Union Switch & Signal Div. Am. Standard Inc. v. United Elec., Radio & Mach. Workers of Am., Local 610*, 900 F.2d 608, 612 n. 1 (3d Cir.1990) (same).

The BAP concluded that it did not have jurisdiction because the second sentence of 28 U.S.C. § 158(a) provides that an appeal of a decision by a bankruptcy judge "shall be taken only to the district court for the judicial district in which the bankruptcy judge is serving." The Court of Appeals agreed with the BAP and therefore affirmed.

Fifth Circuit

Did the bankruptcy court err in authorizing the debtor to reimburse qualified bidders utilizing the business judgment standard of § 363(b) for expenses incurred in connection with the sale of a substantial asset of the bankruptcy estate?

The Fifth Circuit held that the Bankruptcy court did not err in authorizing the debtor to reimburse qualified bidders for expenses incurred in connection with the sale of a substantial asset of the bankruptcy estate. *ASARCO, Inc. v. Elliott Mgmt. (In re ASARCO, L.L.C.)*, No. 10-40930, 2011 WL 3569285 (5th Cir. Aug. 16, 2011).

Parent company of Chapter 11 debtor objected to motion by which debtor sought authorization to reimburse the due diligence expenses of qualified bidders that participated in attempted auction of judgment obtained by debtor against parent company in fraudulent transfer action.

The Court of Appeals held that the business judgment standard, as adopted in § 363(b), applied, and the bankruptcy court properly found that the reimbursement was designed to maximize the value of the estate, was fair, reasonable, appropriate, and in the best interests of all parties. Appellants argued that the bankruptcy court erred in relying on section 363(b) to issue the Reimbursement Order. They assert that the business judgment standard in section 363(b) is too broadly worded to address what they contend is the salient issue here: whether third parties such as the Intervenors may recover expenses incurred in the course of due diligence. In Appellants' view, the correct and applicable standard—the one the bankruptcy court should have applied appears in section 503(b)(1). Under that standard for administrative expenses, Appellants argued, the Reimbursement Order was in error because the requested reimbursements were not actually necessary to preserve the value of the estate.

The Fifth Circuit noted that the business judgment standard in section 363 is flexible and encourages discretion. "Whether the proffered business justification is sufficient depends on the case.... [T]he bankruptcy judge 'should consider all salient factors pertaining to the proceeding and, accordingly, act to further the diverse interests of the debtor, creditors and equity holders, alike.'" *Cont'l Air Lines*, 780 F.2d at 1226 (quoting *In re Lionel Corp.,* 722 F.2d 1063, 1071 (2d Cir.1983)). In contrast, the narrower standard in section 503 of the Bankruptcy Code pertains to entities that have incurred administrative expenses and wish to request payment from the estate. Claims under this section "generally stem from voluntary transactions with third parties who lend goods or services necessary to the successful reorganization of the debtor's estate." *In re Jack/Wade Drilling, Inc.*, 258 F.3d 385, 387 (5th Cir.2001). Subsection 503(b) allows parties to recover administrative expenses "including the actual, necessary costs and expenses of preserving the estate." 11 U.S.C. § 503(b)(1). But as used in this section, "[t]he words 'actual' and 'necessary' have been construed narrowly: 'the debt must benefit [the] estate and its creditors.' " *In re TransAmerican Natural Gas Corp.*, 978 F.2d 1409, 1416 (5th Cir.1992) (quoting *NL Indus., Inc. v. GHR Energy Corp.*, 940 F.2d 957, 966 (5th Cir.1991)); see also *Jack/Wade Drilling*, 258 F.3d at 387 ("[T]o qualify as an actual and necessary cost under section 503(b)(1)(A), a claim against the estate must have arisen post-petition and as a result of actions taken by the [debtor-in-possession] that benefitted the estate." (internal quotation marks omitted)). ■

SSO Commitments *continued from p. 10*

was the potential for a bad actor to "cleanse" a patent portfolio through the use of a strategic bankruptcy[101]. In this scenario, the Debtor (patent licensor) would reject any patent license under 11 U.S.C. §365. If successful, the Debtor organization could then use or assign the patents free of encumbrances such as these RAND license commitments to other parties via the SSO. This would enable the discharged Debtor to use the patents to sue other industry members that had made investments in reliance on the availability of RAND licenses for infringement, a potentially inequitable result. 11 U.S.C. §365(n) appears to address the issue, but may not be sufficiently comprehensive in the SSO context.

CHALLENGES WITH THE CURRENT APPROACH

The licensee rights of §365 were designed with the situation of *Lubrizol* in mind. A licensee having made investments to exploit a license could be effectively put out of business if the license is revoked by a new patent holder after transfer through bankruptcy. In *Lubrizol*, the license was express and royalty bearing[102] rather than cross-licensed, and inchoate as with the startup example supra. While unlicensed patent use may be pervasive even in commercial settings[103], the reassurance of the availability of a RAND license, especially in a cross-licensing industry makes unlicensed practice more rational.

Patents are property which would normally be considered to have well defined boundaries, but some classes of patents (particularly software and business method patents) have been criticized as providing inadequate clarity regarding their scope[104]. The CEO of our example startup may not know whether the startup's software patents have claims reading on the industry standards agreements without the expense of seeking a declaratory judgment or opinion of counsel. Knowledge of the existence and scope of whatever patents or patent applications his coopetition from the SSO may have is even less likely[105]. For a large corporation with thousands of patents, the expense of identifying patents that may read on particular standards agreements may render such an approach even more impractical[106]. Hence, SSO membership agreements typically only require voluntary disclosure of patents where the individual participants have knowledge, and the disclosures often come after the industry standard has been published[107].

The SSO patent policies vary, but may require licensing not just to other members of the SSO, but to anyone who requests such a license from the patent owner[108]. The pool of potential licensees may thus be very large, and those potential licensees may not even be aware that such licensing opportunities are available (even if they correctly identified that one of the thousands of patents issued each year applies to their activities) even though publication of disclosed patents on an SSO website may provide a form of constructive notice. The Nortel bankruptcy is perhaps unusual in that it was a large corporation with other market participants expecting patent related transfers through its bankruptcy. There may not be the awareness (notice) by other market participants in the event of bankruptcy of smaller companies that hold essential patents.

Not all SSOs have the resources to file objections – many operate as non profit organizations with no income streams beyond membership dues and meeting fees to cover operating expenses. Corporations granted rights to seek licenses under an SSO RAND patent licensing policy may not have standing to intervene in the bankruptcy. While the Debtor presumably has some contractual relationship with the SSO, potential licensees that have not consummated a licensing agreement with the Debtor may not have a claim with the scope of §101(5). While the SSO patent licensing policy may obligate the Licensor (now Debtor), the inchoate rights it creates for the licensee do not form a license contract with the Licensor until the specific terms of the license are negotiated. The license agreement is likely to be narrowly construed under §365(n)(1)(B) to the specific patents identified at the time of the bankruptcy. Even a RAND policy requiring a license price of zero (a "RANDZ" or "FRAND" license) may still require negotiation on other terms. These factors lead to a likelihood of the RAND patent policy being a factor in *ex post* licensing negotiations or litigation. When the parties are in patent litigation, they have significant incentives to identify any RAND licensing obligations.

The patent lifecycle, the SSO RAND licensing obligation and the bankruptcy of a competitor happen on independent timescales. The startup's CEO's fear is that after the standard has developed, and many competitors have made investments assuming licensing was possible under RAND terms; there is then a market shakeout leading to the bankruptcy of a the holder of an essential patent; and by cleansing the RAND licensing obligations through a bankruptcy, the new patent owner could disrupt not just one or two creditors, but affect an entire industry. In the increasingly global markets for goods and services, our startup's CEO needs to also consider not only the domestic patents acquired by foreign entities, but also foreign patents in the markets in which the startup needs to compete and the interactions of the bankruptcy laws in those jurisdictions.

ALTERNATIVE APPROACHES

It might be possible to modify §365(n) to make a special case for SSO commitments, but this may be a legislative challenge

Bankruptcy Cases *continues on p. 22*

101 Transcript of FTC Workshop on IP Rights in Standard Setting held June 21, 2011 available online at http://www.ftc.gov/opp/workshops/standards/transcript.pdf at 226-27 (identifying as a potential problem area the transfer of patent rights during bankruptcy where those rights had licensing commitments developed through standards organization); see also Comments of International Business Machine Corporation (Marc Sandy Block) 8/4/2011 available online at http://www.ftc.gov/os/comments/patentstandardsworkshop/00037-80151.pdf at 17-18

102 *Lubrizol Enterprises Inc v Richmond Metal Finishers Inc.(in re Richmond Metal Finishers, Inc.*), 756 F.2d 1043,1046 (4th Cir 1985) ("Lubrizol owed RMF the unperformed and continuing duty of accounting for and paying royalties for the life of the agreement.")

103 Eisenberg, note [4] *supra* at 54 ("unlicensed use is likely pervasive in other settings as well, including commercial production")

104 *See e.g.,* J. Bessen, M. Meurer, Patent Failure: How judges, bureaucrats and lawyers put innovators at risk, Princeton University Press, NJ 2008, ISBN 978-0-691-13491-8 (arguing that software patents do not provide adequate notice because claims are often vague or overly abstract)

105 Eisenberg, note [4] *supra* at 67 ("It is costly to identify unknown rights and to monitor the behavior of strangers.")

106 *See e.g., In Re Qimonda AG Chapter 15, Debtor*, Note [90], at 15

107 Transcript of FTC Workshop on IP Rights in Standard Setting held June 21, 2011 available online at http://www.ftc.gov/opp/workshops/standards/transcript.pdf at 41-43 (describing analysis of patent disclosures at ETSI)

108 *See e.g.*, Letter of Assurance request by IEEE available online at https://development.standards.ieee.org/myproject/Public//mytools/mob/loa.pdf

SSO Commitments *continued from p. 21*

to identify the specific exemption language given the range of potential licensees created under some SSO patent policies. Since §365(n) was added in 1988, there have been very few reported cases of patent owning Debtors rejecting license obligations[109]. Adding complexity to the bankruptcy code may be overkill if that situation does not occur very often. An essential patent, however, could disrupt an entire industry's cross-licensing assumption (as the *Nortel* and *Qimonda* bankruptcy cases demonstrated) and force them to pass on licensing costs to downstream consumers.

Notice is typically provided to specifically identified licensees, but this currently would not necessarily include the SSOs. While the Debtor may recognize a current or former SSO membership as entailing *potential* contractual obligations to negotiate future agreements, it may not be recognized as a current patent license agreement if specific patents and other parties are not identified. Requiring specific notice to SSOs of which the Debtor was a member may be more practical. Perhaps this could be reduced to just those SSOs where the Debtor has declared the existence of essential patents if there was a need to trade off completeness versus the expense of the notice arrangements. An alternative approach through patent law could also improve notice by requiring license commitments (including SSO commitments) to be registered along with the registration of the patent title at the PTO.

SSO practices and patent policies could be changed to require more effective disclosure and infringement analysis by patent holders, or to require actual licenses or cross licenses be established within a specific timeframe rather than the current inchoate licensing obligation. ANSI recently held a legal issues forum considering aspects of patents in standards[110]. The National Academy of Science has also initiated a project in this area[111]. Changes to the patent declaration procedures required for participation adds costs to the standardization process and may reduce the number of standards developed, possibly reducing innovations and impeding markets. Available econometric evidence appears to be rather limited on this point. Regulatory initiatives (e.g. the FTC) could impose similar constraints by fiat, but have similar risks of creating greater impediments than they resolve.

While notice could be improved by changes to Bankruptcy Law through specific notifications to SSOs, the larger challenge here seems to lie within Patent Law and the industry practices of the various SSOs. Indefinite patents create uncertainty that is untenable in the bankruptcy context. Ill-defined patents in the hands of competitors may give our startup's CEO pause during normal times; but once the bankruptcy clock starts ticking it is too late to go back and negotiate a RAND license from the competitor. Instead, our CEO must deal with the new patent entrepreneur; who may have a very different set of licensing objectives. Rather than relying on others' unilateral promises through the SSO for future license negotiations on RAND terms, our CEO should insist on obtaining concrete licensing arrangements as soon as practical. Mechanisms that reduced the time and costs of patent compliance checks could significantly reduce the uncertainty for our startup's CEO. Without them, the "fresh start" provided by a bankruptcy reorganization to a competitor not only reorganizes and re-energizes that competitor, but also creates opportunities for new patent entrepreneurs (also known as "patent trolls") to disrupt the industry, resulting in increased litigation and licensing costs passed on to consumers. ■

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109 *See e.g., In re Qimonda*, 433 B.R. 547, 559-64(2010)(providing statutory analysis of whether §365(n) applies automatically in Chapter 15 proceedings because this is an issue of first impression); Menell, note [22] *Supra* at 781 (identifying only one reported case on a licensor's rejection).

110 http://www.ansi.org/meetings_events/wsw11/LegalIssuesForm_proceedings.aspx?menuid=8

111 http://www8.nationalacademies.org/cp/projectview.aspx?key=49398

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Accounting for Reorganization Items *continued from p. 12*

The benefits of using the Method 2 approach include:

- Consistency of segregation of bankruptcy related costs by identifying non-recurring items separately from the results of operations, both during and after emergence from bankruptcy. For example, we have seen a number of exit financing agreements that allow entities to exclude items that meet the definition of Reorganization Items (incurred before or after emergence) from earnings related calculations when determining compliance with debt covenants.
- Use of the Reorganization Items line item on the statement of operations by the successor entity provides consistency with comparable companies that have not emerged from chapter 11.
- Separating the reorganization items from operating income allows for easier comparison of future periods for the successor entity.

SUMMARY

Companies that have filed chapter 11 are required to account for, disclose and present Reorganization Items in their statements of operations while operating in bankruptcy.

There is inconsistency in how entities classify incremental costs that are related to the reorganization and restructuring of the business and incurred after exiting chapter 11. Many companies that have recently emerged from chapter 11 have concluded that it is appropriate to continue to classify non-operating, non-recurring items that are direct and incremental to the entity's reorganization as Reorganization Items in the statement of operations. This presentation may be beneficial to readers of financial statements as it provides a transparent, consistent method for informing users of the nature and amount of the costs of the chapter 11 reorganization. ■

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Bankruptcy Valuation

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Predicting Municipal Bankruptcy: From Z-Score to M-Score

INTRODUCTION

In addition to the world of corporate bankruptcies and Chapters 7 and 11 is the world of municipal bankruptcies and Chapter 9.[1] The Bankruptcy Code defines a municipality as a political subdivision or public agency or instrumentality of a State. As seen from the legislative history of Chapter 9, Congress intended the definition of municipality to be interpreted broadly. Thus, "political subdivision" generally includes cities, counties, and townships, and "public agency" and "instrumentality of a State" generally include hospital districts, public finance authorities, public improvement districts, school districts, and other revenue-producing bodies that are sponsored or controlled by the state.[2]

Compared to Chapter 11 corporate filings, Chapter 9 municipal bankruptcy filings are relatively rare. Since the original municipal bankruptcy legislation was enacted in 1934, there have been only about 630 Chapter 9 filings.[3] However, since December 2010, analysts have been predicting an increase in municipal defaults and bankruptcies. During 2010, there were seven Chapter 9 cases filed; in 2011 there were thirteen Chapter 9 filings, five of them during the last quarter.

Famous for "The Call" made on October 31, 2007 that foretold the Great Recession, analyst Meredith Whitney made a December 19, 2010 prediction of hundreds of billions of dollars' worth of defaults by cities and states.[4] A few months later on February 28, 2011, a report by "Dr. Doom" Nouriel Roubini forecasted municipal defaults totaling $100 billion over the next five years.[5] Recently there have been harbingers of possible realization of these predictions: In October 2011 Harrisburg, Pennsylvania, became the first state capital to file municipal bankruptcy; in November 2011, Jefferson County, Alabama, filed the largest Chapter 9 municipal bankruptcy in U.S. history.

The current nationwide distress of U.S. local governments represents a rare extended opportunity for bankruptcy and turnaround professionals to assist the very towns, villages, cities, and counties in which we live. However, bankruptcy and turnaround professionals wishing to advise struggling municipalities lack tools and methodologies comparable to those available for distressed corporations. Given the relative rarity of municipal bankruptcies vis a vis corporate bankruptcies, the dearth of academic research in municipal distress is not surprising.

DEVELOPING THE M-SCORE

It has been proposed that it is possible to develop novel frameworks and tools specifically for municipal distress, based upon such disciplines as government accounting and reporting, public budgeting, municipal management and public finance. As described in a paper by Elise Mochizuki, the "M score" refers to the potential to predict municipal bankruptcy using a model similar to the Z score, with the assumptions that municipalities can be financially analyzed like companies and that accounting based measures are applicable to municipal default prediction.[6]

Credit risk approaches that could potentially be included in a predictive method applicable to municipal bankruptcies include traditional credit analysis, credit ratings, credit risk models, and credit scoring. Multiple discriminant analysis (MDA) is the statistical approach used in the Z score for corporate bankruptcy prediction. A modified MDA function could have predictive power for municipal bankruptcies and would be given in the form: $M = V1X1 + V2X2 + \ldots + VnXn$ where M is the municipal bankruptcy prediction score and V is a discriminant coefficient with different weightings for each independent variable, X.

In Mochizuki's study on the possibility of developing an M score, data was collected from Chapter 9 municipal bankruptcies from 1980 t0 2011 and a sample of 147 was selected for the study which revealed, among other findings, that the most common immediate causes of the Chapter 9 bankruptcy filings were[7]

1. large lawsuit judgments (e.g., Boise County, Idaho, March 1, 2011)
2. unfavorable labor contracts (e.g., Central Falls, Rhode Island, August 1, 2011)
3. bankrupt real estate developments (e.g., Harrisburg, Pennsylvania, October 12, 2011)

These causes of Chapter 9 filings are considered to be candidate independent variables, along with over a dozen potentially relevant financial ratios, in the potential development of an M score for use in predicting municipal bankruptcies. I will report further on research in this area in a future issue.

ALTMAN'S Z-SCORE

A detailed look at the Z score is instructive due to its importance in assessment and predictions related to distressed businesses. Use of the Z score is included in the CIRA Part 2 curriculum; however, most users are only familiar with the original 1968 formula and simple calculations, not with the underlying statistics or the improved 1977 ZETA score. The following is a summary of Edward I. Altman's 1968 paper that first proposed the Z score.[8]

Around the time the Z score was developed, traditional ratio analysis was falling out of favor in the academic community and

Bankruptcy Valuation *continues on p. 26*

1 11 U.S.C. § 109(c)
2 Nguyen, Triet. (2012). Investing in the high yield municipal market: How to profit from the current municipal credit crisis and earn attractive tax-exempt interest income. *Chapter XX: Managing Bond Defaults and Bankruptcies* by Kenji Mochizuki. http://www.amazon.com/Investing-High-Yield-Municipal-Market/dp/1118175476/ref=sr_1_1?s=books&ie=UTF8&qid=1327944904&sr=1-1
3 Administrative Office of the U.S. Courts http://www.uscourts.gov/Statistics/BankruptcyStatistics.aspx
4 McDonald, D. The prophet motive. Wall Street Journal, September 29, 2011.
5 Dr. Doom's firm expects $100B in muni defaults. Bloomberg News, March 2, 2011. http://www.crainsnewyork.com/article/20110302/FREE/110309959
6 Mochizuki, E., and Mochizuki, K. Novel multifactoral model for predicting municipal bankruptcy, November 11, 2011. Proceedings of the 2011 Sigma Xi Annual Meeting and International Research Conference. PR-20, p. 81.
7 *Ibid.*
8 Altman, Edward. Financial ratios, discriminant analysis and the prediction of corporate bankruptcy. Journal of Finance, Vol. XXIII, No. 4. (September 1968), pp. 589-609.

Bankruptcy Valuation *continued from p. 25*

efforts to predict corporate bankruptcy were largely univariate. By combining the statistical concept of MDA with ratio analysis, Altman developed a discriminant-ratio model that increased the statistical significance of ratios within a multivariate framework. MDA increased the potential of traditional financial ratios as predictors of bankruptcy.

With a sample size of n=66 with 33 manufacturers that filed a bankruptcy petition under Chapter X of the National Bankruptcy Act, 33 non-bankrupt manufacturers were randomly selected from a pool stratified by industry and by size. Financial data were derived from financial statements one reporting period prior to the bankruptcy filing. Based upon popularity and relevancy, initially 22 ratios (variables) were classified into 5 categories, i.e. activity, leverage, liquidity, profitability, and solvency ratios. Ultimately 5 ratios (variables) were found that together best predicted corporate bankruptcy.

A computer program specifically for MDA was used. After estimating the values of the discriminant coefficients, discriminant scores for each firm could be calculated. As expected, the discriminant coefficients of the Z score equation (see formula below) displayed positive signs, suggesting that the greater a firm's bankruptcy potential, the lower its discriminant score (Z score). The final discriminant is as follows:[9]

$$\text{(I)}\qquad Z = .012X_1 + .014X_2 + .033X_3 + .006X_4 + .999X_5$$

where X_1 = Working capital/Total assets
X_2 = Retained Earnings/Total assets
X_3 = Earnings before interest and taxes/Total assets
X_4 = Market value equity/Book value of total debt
X_5 = Sales/Total assets
Z = Overall Index

A statistical F test was performed to assess the individual discriminating ability of the variables (ratios). The significance allowed the rejection of the null hypothesis that the observations come from the same population. In other words, the a priori groups of bankrupt and non-bankrupt manufacturers were significantly different.[10]

Altman's paper finishes with a series of six tests that were performed to establish the best model. In the first test, the initial sample of 33 firms in each of the two groups (bankrupt and non-bankrupt) was examined using data one financial statement prior to bankruptcy. The discriminant model correctly classified 95 percent of the sample firms; e.g., classifying bankrupt firms as bankrupt and non-bankrupt firms as non-bankrupt. In the second test, both groups of bankrupt and non-bankrupt firms were examined using data from two years prior to bankruptcy. The discriminant model correctly classified 83 percent of the sample firms.[11]

In the third test regarding potential bias and validation techniques, the firms used to determine the discriminant coefficients were re-classified. The resulting accuracy was biased upward by sampling errors in the original sample as well as nonsignificant search bias resulting from reducing the original set of 22 variables (ratios) to the best variable profile of 5 ratios.[12]

9 *Ibid.*, p. 594.
10 *Id.*, p.596
11 *Id.*, pp.599-600
12 *Id.*, p.600

In the fourth test, a new sample of 25 bankrupt firms was selected, and the results compared to that of the original sample. The discriminant model correctly classified 96% of the sample firms, an improvement over 94 percent. In the fifth test, a new sample of 66 non-bankrupt firms was selected, 33 from one year, and 33 from another year. The discriminant model correctly classified 79 percent of the sample firms, an improvement over 72 percent.[13]

In the sixth test regarding long range predictive accuracy, the observed ratios deteriorated as bankruptcy approached, and the most serious change in the ratios occurred between the third and the second years prior to bankruptcy. The results suggested that the Z score was accurate in forecasting failure up to two years prior to bankruptcy, and that the accuracy diminished substantially as time increased from the bankruptcy filing.[14]

ALTMAN'S Z-SCORE+

Subsequent to the original Z score that covered industrial, publicly-held manufacturing firms, Altman has addressed several additional factors. The Z' score covers industrial privately-held manufacturing firms; the Z'' score covers industrial private and public non-manufacturing firms in the U.S. and abroad including foreign firms located in emerging markets.

In January 2012, Altman released a desktop and mobile app version "Altman Z-Score +" for Apple iOS (iPhone and iPad), Google Android and Blackberry mobile devices (web interface is provided for users who do not already own Excel). However, Z-Score+ is not just an app version or online version of Z score, Z' score, and Z'' score. It contains three new features: 1) non-U.S. companies, including those in emerging markets such as China; 2) the assignment of a 1-to 10-year probability of default; 3) the percentile ranking likelihood of bankruptcy by industrial category; and 4) the bond-rating equivalent (BRE) for each company that compares its most recent Z, Z' or Z''-Score with the average score for appropriate bond rating classes from AAA to D (default).[15]

AIRA members are offered a 20% discount on purchase of the Z-Score+ app and subscription (see https://www.aira.org/zscore). ■

Kenji Mochizuki, CIRA, AIRA Journal Section Editor, currently works in bankruptcy / restructuring / M&A advisory as well as distressed investing, which includes serving as advisor to a distressed municipal bond hedge fund and heading a team of credit analysts. Kenji is the author of the chapter on municipal defaults and bankruptcy in a John Wiley & Sons, Inc. / Bloomberg Press book currently in press entitled, "Investing in the High Yield Municipal Market". He can be contacted at kenji@akemicapital.net

13 *Id.*, pp.601-603
14 *Id.*, p.604
15 The "Altman Z-Score + App" for Assessing the Credit Risk of Companies, The Finance Professionals' Post, the New York Society of Security Analysts (NYSSA), January 19, 2012, http://post.nyssa.org/nyssa-news/2012/01/the-altman-z-score-app-for-assessing-the-credit-risk-of-companies.html

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