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Intellectual Property Licensing and Value Issues in Bankruptcy: Assessing the Risk to Experience the Reward

Intellectual property (IP) represents one of the most significant and fastest growing sources of a corporation's earnings. Commenting on the rising trend that started decades ago and continues today, former Federal Reserve Chairman Alan Greenspan reflected: "In recent decades, the fraction of total output of [the U.S.] economy that is essentially conceptual rather than physical has been rising. The trend has, of necessity, shifted the emphasis in asset valuation from physical property to intellectual property and to the legal rights inherent in intellectual property."

That was 1984. Since then, revenue generated from the commercialization of IP continues to propel businesses into record-setting profits. IP represents a significant portion of a company's reported intangible value as well. In 2011, the Wall Street Daily Insider reported that S&P 500 companies have an estimated \$7 trillion worth of intangible assets sitting idle. Even in a healthy economy, IP cannot overcome poor management and the fickle nature of the market. But with the continuing financial crises, even the most venerable corporations are vulnerable to failure, and industry experts predict that the volume of big-business bankruptcies will double in 2012.2 Considering these elements together, the current market offers ample opportunity for investors to acquire valuable IP and perceptive prospectors are evaluating the risks and rewards of purchasing such distressed assets.

Valuation in the News—IP in Bankruptcy

Take the case of Nortel Networks. With 6,000 patents, Nortel took the strategic position of selling its patent portfolio, which included patents and patent applications for wireless technologies, wireless

4G, data networking, optical, voice, Internet, and semiconductor technologies. As part of its bankruptcy proceedings in 2011, Nortel auctioned its patents to a consortium of technology companies for an average of \$750,000 each. The resulting \$4.5 billion sale price yielded considerably more for Nortel than Google's original \$950 million offer price for the patents.

While companies in bankruptcy present unparalleled opportunities for entities looking to acquire additional or complementary IP, they also can present many challenges. Eastman Kodak is a good example.

Kodak filed for Chapter 11 bankruptcy in January 2012. According to court filings, the company received \$450 million in annual licensing revenue on its digital imaging patents from 2003 to 2010. But in 2011, amidst speculation concerning Kodak's liquidity problems, potential licensees delayed signing deals, resulting in Kodak's reported collection of only \$100 million in licensing fees. Despite the low licensing revenue, Kodak's portfolio of imaging patents, with an estimated value of between \$2.2 billion and \$2.6 billion, continues to generate great interest.

In June 2012, Kodak filed a motion to auction 1,100 digital imaging patents in order to help fund its reorganization. The company wants to leverage its patents and slim down its product offerings as it shifts its focus from photography to printing. The bankruptcy court approved the request, and the auction was in process at the time of this writing. There are, however, outstanding issues regarding Kodak's right to sell certain of these patents. Kodak is currently in litigation with Apple and FlashPoint Technology, which have both asserted an ownership interest in several of the patents being sold. This begs the question: Is IP purchased in a bankruptcy sale owned free and clear by the buyer?

IP Licensing continues on p. 4

^{1 &}quot;While Wall Street Dozes, Here's Your Piece of a \$7 Trillion Pie," Wall Street Daily Insider, May 16, 2011.

^{2 &}quot;Bankruptcies 2012: Doubling Down," CNN Money, January 14, 2012.

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New CIRAs and CDBVs

New AIRA Members



A Letter from the President

Anthony V. Sasso, CIRA *Deloitte CRG*

AN INVITATION TO CHICAGO AND AIRA'S 29TH ANNUAL CONFERENCE

I have been eagerly anticipating this year's Annual Conference taking place **June 5-8, 2013, at The Westin Chicago River North**. We can look forward to an outstanding educational program and opportunity to mingle with fellow members and distinguished guests, reinvigorating old friendships and initiating new ones.

On Wednesday, June 5, the preconference program offers a choice between two full-day sessions, **Bankruptcy Taxation** and **Financial Advisors' Toolbox**, both with impressive panels including financial and legal experts, U.S. trustees and bankruptcy judges. Wednesday's luncheon program features **Camisha L. Simmons**, an associate with Fulbright & Jaworski, who will address "Emerging Healthcare Privacy Concerns in Bankruptcy."

The main conference program opens Thursday, June 6 with a presentation by **Bob Wiedemer**, economist and author of *America's Bubble Economy* (the landmark book that predicted the downturn in the economy in 2006), *Aftershock* and *The Aftershock Investor*. Our special guest speaker for Friday's luncheon program will be **Grant Achatz**, world-renowned chef and restaurateur, winner of numerous accolades including James Beard Foundation awards for Outstanding Chef and Rising Star Chef. The keynote speaker at Thursday evening's Annual Awards Banquet will be **Lynn Osmond**, president of the Chicago Architecture Foundation.

It is a real pleasure to have another occasion to visit the "Windy City" and all the rich history and culture that it has to offer. Attractions in or near Chicago are numerous (to say the least) and the conference program will provide a sample of some of the best on Thursday afternoon, including a **golf outing at Harborside International, Chicago Architecture River Cruise, Segway Tour, and hands-on cooking class**. Friday evening will beckon us to U.S. Cellular Field (formerly Comiskey Park) to see the **Chicago White Sox v. Oakland Athletics**—fans will be treated to a fireworks show after the game.

With regard to the schedule of conference presentations and concurrent sessions, I am impressed by the breadth and depth of the important topics covered as well as the quality of the speakers and panelists. I want to express my sincere thanks to the conference chairs, planning committee, and the AIRA team for their significant efforts. **AIRA's 29th Annual Bankruptcy & Restructuring Conference** will be a fantastic opportunity to enhance your continuing professional education and enjoy many remarkable experiences.

Finally, be sure to plan now to attend AIRA's 30th Annual Conference June 4-7, 2014, in Denver—a beautiful setting for this big event, as you can see in the photo at right!

I look forward to seeing you in the Windy City,

Tony Sasso

Anthony Sasso, CIRA



Executive Director's Column

Grant Newton, CIRA AIRA Executive Director

The reputation of any profession depends on the ethical standards and behavior of its members. In general I am impressed by the ethics of the financial advisors that render

services in bankruptcy and restructuring. However I am concerned by some actions commonly taken to recover preferences which do not seem consistent with standards we hope would be upheld by financial advisors, attorneys and others that provide recovery services. During the last few years several letters have come to my attention in which financial advisors or other professionals were associated with questionable recovery practices.

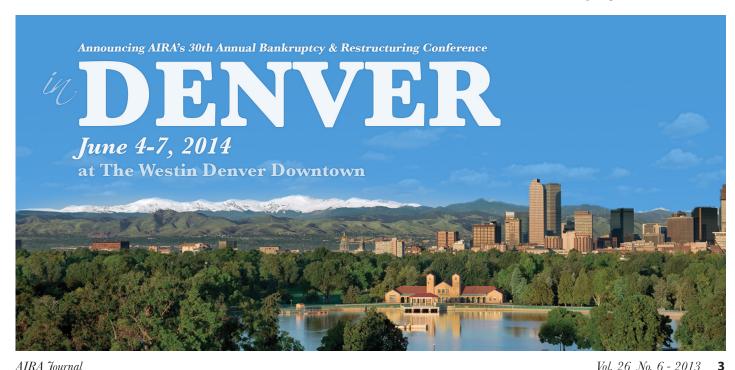
For example one of these letters, sent on behalf of a business concern to a small creditor, began by stating, "Sections 547 and 550 of the Bankruptcy Code empower a debtor or a trustee to recover payments made to creditors during the debtor's bankruptcy filing, as such payments are deemed to be 'preferential transfers." After pointing out that the purpose of the "preferences section" of the Bankruptcy Code is to facilitate the policy of equitable distribution among creditors of a debtor, the firm sending the letter referred to its authority to recover preferences from creditors and quoted the Litigation Trustee as stating "according to the Debtor's records, the creditor received approximately \$3,943.50 during the 90day preference period." In this case there clearly was no right to recover the payments because section 547(c)(9) provides the trustee may not avoid under this section a transfer if, in a case filed by a debtor whose debts are not primarily consumer debts, the aggregate value of all property that constitutes or is affected by such transfer is less than \$5,475 in petitions like this one which was filed before April 1, 2013 (\$6,225 after March 31, 2013). The

letter went on to state as is common in such communications that the Litigation Trustee had offered to accept a percent of the total (in this case 80 percent of the amount determined as preferences) as payment in full if payment were received within a short time after the notice was mailed. It was very generous to offer to settle for 80 percent, since eighty percent of zero is still zero! A final flaw in the letter was the failure to recognize that section 1409(b) provides action for this type of small recovery must be commenced in the district where the defendant resides, which did not occur in this case.

In most of these letters I have seen it is usually pointed out that a favor is being done for the creditor by reducing the amount that must be returned by some percent (e.g., 20%) if only they will send payment within a short time after the letter is received (in other words, do not waste time calling your attorney).

In another such letter the financial advisors stated they had "reviewed the conditions under which the payments were made" and there were no exceptions applicable to the "preferential payments" that had been received from the creditor. As it turned out, in this case there were applicable exceptions for each of the payments the financial advisor indicated were preferences.

The question I put forth is, Is it an ethical practice to attempt to recover payments in the manner described in these exampleswhich seem to take advantage of the fact that the creditor (often a small business) will often not be familiar with the provisions of the Bankruptcy Code and in ignorance will send a check for an amount which it (the creditor) has no obligation to pay? It is my understanding that the U. S. Trustee's office is aware that letters of this nature are being sent to creditors, but has unfortunately, not objected to their use as far as I know. I invite members to share their views on this matter with AIRA's group on LinkedIn.



IP Licensing continued from p. 1

In the case of Kodak, the answer is "yes"— according to Timothy Lynch, Kodak Vice President and Chief Intellectual Property Officer. Responding to the Court's decision, he said that, "the ruling provides a Court-approved process allowing buyers to acquire the patents free and clear of all ownership allegations, regardless of the status of the dispute with Apple and FlashPoint at the time of closing." The Kodak digital imaging patents were eventually sold for \$525 million in January 2013 to a consortium led by Apple, Google and Microsoft.

As the Kodak case illustrates, ownership and right-to-use issues can complicate the sale of any type of IP, but can be particularly complex in a distressed environment, because of the bankruptcy court's ability to reject contracts to which the debtor is a party. Later in this article we will explore whether a licensee's right to continue using the IP is severed by such a rejection.

Valuation Methodologies for Any Situation— Premise of Value

Integral to determining the value of IP is identifying the valuation premise—understanding how the IP will be used to generate both current and future returns. Determining the valuation premise is particularly important in bankruptcy, where a distressed disposition can significantly impact valuation. Although the upside can be substantial, valuing a distressed asset requires keen judgment.

While there can be a unique twist to the methodologies for distressed companies, the three basic approaches to valuing any asset include:

- Market Approach—value is based on similar historical market transactions of comparable assets;
- 2. Cost Approach—value is based on projected costs to replace or reproduce the asset; and
- 3. Income Approach—value is based on the anticipated economic benefit from using the asset.

Distress Leads to Unique Valuation Issues

Under ordinary circumstances, asset value is determined through negotiation by a willing buyer and a willing seller. In a bankruptcy context, the sale process can be accelerated. Inherently the seller, because of the distressed environment, is disadvantaged. As the buyer predictably exerts downward price pressure, the ultimate selling price of the asset can be further reduced. If the bankrupt entity is liquidating, as opposed to reorganizing, the asset's selling price can be reduced even further.

Liquidation discounts can vary from as low as 30 percent to as much as 90 percent and sometimes more. According to Fundamentals of Property Valuation," as each month passes, the value of the IP or intangible asset decreased by 2 percent to 5 percent (databases, mailing lists, and technical know-how will degrade more quickly than trademarks and brand assets)." The bankruptcy valuation equation may be expressed as: going-concern value, less a liquidation discount, less a further discount

for competitive bankrupt asset offerings, with the result being a realistic and attainable market value.³

Understanding the underlying cause of the bankruptcy or reorganization will help to establish the asset's value. Using the above calculation and factoring in the business potential or liquidation value will yield the current market value of the distressed IP.

What exactly does the debtor own, and what ownership can the debtor convey? Those are critical questions for the prospective investor. A debtor can only convey the ownership of IP that it owns outright. But even in Kodak's case, if the lawsuits with Apple and FlashPoint are not fully resolved by the time of patent sale, Kodak may still sell the patents free and clear of the litigants' claims by establishing "adequate protection" under Section 363 of the U.S. Bankruptcy Code. According to Kodak's website, the company's "adequate protection could take many forms depending on the value of any remaining alleged interests, the amount of the sale proceeds, and other factors." Alternatively, the bankruptcy court also authorized Kodak to sell the patents subject to Apple and FlashPoint's claims, if mutually agreed between Kodak and the winning bidder.

Resources

Within any corporation, particularly in a distressed environment, IP can be fragmented. Mining all of the relevant IP from an entity can mean the difference between success and failure for the new venture. Unfortunately, taking an inventory of what the debtor owns can be a complicated process. As financial statement auditors can attest, management often is unaware of all the types of IP a company owns. Many companies do not maintain an itemized listing of IP, and as investors and other employees knowledgeable about particular elements of IP depart a company, it becomes more and more difficult to even begin to develop an itemized listing. This makes valuation determinations all the more difficult.

Success for the new venture lies in the ability to quickly identify the critical value components of the IP assets. Effectively maximizing value and converting the IP into a revenue generating asset is crucial. This process can be expedited by retaining employees with institutional knowledge of the IP—those individuals who have managed and implemented the IP—or through a knowledge transfer. However, vital knowledge concerning the IP may have departed with key employees long before the actual bankruptcy filing. Investors must be prepared for further research and investment, beyond the sale price, before the IP can be primed and ready to use to its fullest potential.

Once a company files for bankruptcy, even previously consistent revenue streams can be suddenly compromised. Clients, vendors, and service providers generally are reluctant to enter into new contracts with a bankrupt entity, which affects future revenue streams and increases financial instability. This can reduce the IP's sale value even as it attracts competing bidders who may escalate the price. Rejected contracts can lead to adversarial proceedings that can attach to the IP and impact value, as is the case with

³ Anson, Weston, IP in Bankruptcy, Reorganization, and Securitization, Fundamentals of Intellectual Property Valuation.

Kodak, where Apple asserts that Kodak is attempting to strip Apple of its rights under federal patent and state law.

Ultimately, the investor must determine whether the distressed IP has synergy with the new entity's current product offerings and whether the new IP creates operating cost economies or production efficiencies for application-specific software, enterprise information infrastructure, or proprietary methodologies. On the sales side, investors must identify any commercial or strategic opportunities to appropriately deploy the new resource.

Prospecting in Bankruptcy Proceedings to Acquire Intellectual Property

The confluence of IP and bankruptcy laws often leads to a balancing of conflicting interests. The goal of bankruptcy reorganization is directed to rehabilitating debtors and maximizing the value of the debtor's asset for the benefit of its creditors. This requires providing a debtor with flexibility to market and monetize its intellectual property assets. The goal of parties entering into IP licenses generally is to provide protections against erosion of asset value and a revenue stream to the owner of the IP. Understanding how these disparate goals are served at their intersection is imperative to prospective buyers of any type of IP asset from a bankruptcy estate.

In the bankruptcy context, there are a number of critical issues a prospective buyer of IP must evaluate before stepping into the purchasing arena. First, as discussed above, the prospective buyer must determine who actually owns the IP at issue and what role the owner has in the bankruptcy proceedings. Closely tied to ownership is the issue of whether the IP is encumbered by a licensing agreement and, if so, what type of license is involved. For example, is the owner of a patent the actual debtor? In that instance, the prospective buyer might be looking to acquire all rights, title, and interest in and to the patent itself. If, on the other hand, the debtor is the exclusive licensee of the patent, the prospective purchaser may be looking to acquire by assignment the licensed rights in the patent.

Another important aspect of the prospective buyer's due diligence is to determine the classification of the IP at issue. Is it a patent, copyright, trademark, trade secret, or other type of intangible asset? Determination of this seemingly simplistic question has significant ramifications on the bankruptcy laws that will apply to a potential buyer's ability to acquire the IP asset or parts thereof.

Truly tricky situations exist when IP assets entangled in a bankruptcy proceeding are subject to existing license agreements. A prospective buyer must effectively navigate a host of legal issues before it can walk away from the proceedings with value.

Licensed IP Involved in Bankruptcy Proceedings

Under U.S. bankruptcy law, the trustee or debtor-in-possession (DIP) has broad powers in dealing with contracts involving the bankrupt party. Pursuant to Section 365 of the Bankruptcy Code, a Chapter 11 debtor may reject, assume, or assume and assign an executory contract.⁴ Although not specifically defined in the Bankruptcy Code, "executory contracts" generally are

4 11 U.S.C. § 365.

understood to be contracts to which "performance remains due to some extent on both sides." Although the issue of whether the subject license is executory must be determined by the interested IP purchaser, by and large IP licenses are considered "executory."

"Assuming a contract" simply indicates that the contract's existence will continue forward. That is, the debtor chooses to be bound by the terms of the contract. From the date of the assumption going forward, both parties must comply with the contract's terms as if there had been no bankruptcy, assuming certain pre-conditions are met such as curing any existing defaults or providing "adequate assurances" that the debtor will so do.⁷

The Bankruptcy Code also allows a debtor, in certain circumstances and after satisfying certain conditions, to assume and assign the contract. Generally, a debtor may assign an executory contract even when the contract specifically prohibits or limits assignment.⁸

With "rejection," however, the debtor refuses to be bound by the contract. Under the Bankruptcy Code, rejection is deemed a breach of the contract by the debtor. Rejection gives the non-debtor a pre-petition claim for damages caused by breach of the contract.⁹

Rejection, assumption, and assumption and assignment each have important implications with respect to IP licenses held by the debtor. A prospective purchaser would be well-served by understanding the implications of each with respect to the different types of IP and the particular language of licenses securing those assets and their usage.

Rejection—Can the Licensor-Debtor Bring an End to an Existing IP License?

The ultimate question with respect to a rejected executory contract is whether the contract comes to an end as a result of the rejection. As it relates to IP, does rejection terminate the non-debtor licensee's ability to use and/or practice the IP? The answer likely is dependent on the type of IP being licensed.

In 1988, Congress added Section 365(n) to the Bankruptcy Code to provide IP licensees certain protections from rejected licenses. ¹⁰ If the DIP or Trustee rejects an IP license under Section 365(n), the licensee can elect to either (1) treat the license as terminated or (2) retain its rights to the licensed IP, including the right to enforce exclusivity provisions of the license. Section 365(n) was added "to make clear that the rights of an intellectual property licensee to use the licensed property cannot be unilaterally cut off...in the event of the licensor's bankruptcy." ¹¹

IP Licensing continues on p. 28

- 5 NLRB v. Bildisco and Bildisco, 465 U.S. 513, 522 n. 6 (1984).
- 5 See Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc., 756 F.2d 1043 (4th Cir. 1985), cert. denied, 475 U.S. 1057 (1986).
- 7 11 U.S.C. § 365(b)(1).
- 8 11 U.S.C. § 365(e).
- 9 See Szilagyi v. Chicago Am. Mfg., LLC, 459 B.R. 306, 341 (Bankr. N.D. Ill. 2011).
- 10 Intellectual Property Bankruptcy Protection Act of 1988, Pub. L. No. 100-506, 102 Stat. 2538 (1988). Congress added Section 365(n) to specifically address the Fourth Circuit's 1985 decision in Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc., 756 F.2d 1043 (4th Cir. 1985), cert. denied, 475 U.S. 1057 (1986), discussed supra.
- 11 In re Qimonda AG, 462 B.R. 165, 180 (Bank. E.D. Va. 2011).

The Consumer Financial Protection Bureau ("CFPB") ¹

Baxter Dunaway

Pepperdine University School of Law

Introduction and Creation of the CFPB

Beginning in 2007, the United States faced the most severe financial crisis since the Great Depression. Millions of Americans saw their home values drop, their savings shrink, their jobs eliminated, and their small businesses lose financing. Credit dried up, and countless consumer loans—many improperly made to begin with—went into default.

For many decades, rising wages and growing savings meant that American families tended to carry only modest amounts of debt. But wage stagnation that began in the 1970s—combined with rising expenses for housing, health care, transportation, child care, and taxes—pushed more families into debt. At the same time, households saw a significant increase in access to credit, and many of the old rules regulating credit were gone. In the 2000s, there were widespread failures in consumer protection and rapid growth in irresponsible lending practices. Many lenders took advantage of gaps in the consumer protection system by selling mortgages and other products that were overly complicated.

This left many Americans with loans that they did not fully understand and could not afford. Although some borrowers knowingly took on too much debt, millions of Americans who behaved responsibly were also lured into unaffordable loans by misleading promises of low payments. Honest lenders that resisted the pressure to sell complicated products had to compete with their less responsible competitors.

Even those who avoided the temptations of excessively risky credit were caught in its web. Those who never took out an unaffordable mortgage nonetheless saw the values of their homes plummet when neighbors lost homes in foreclosure. Those who used credit cards and home equity lines of credit judiciously saw across-the-board increases in interest rates on credit cards and contraction of outstanding lines of credit. Also those who had saved regularly saw their retirement funds lose significant value and their cities and states cut back on services to make up for their own revenue losses.

In June 2009, President Obama proposed to address failures of consumer protection by establishing a new financial agency, the Consumer Financial Protection Bureau ("CFPB"), to focus directly on consumers, rather than on bank safety and soundness or on monetary policy. This new agency would heighten government accountability by consolidating in one place responsibilities that had been scattered across the government agencies.

In July 2010, Congress passed and President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act.²

The Act created the Consumer Financial Protection Bureau ("CFPB"). The CFPB consolidates most Federal consumer financial protection authority in one place. The consumer bureau is structured to be focused on one goal: watching out for American consumers in the market for consumer financial products and services.³

The CFPB is designed to consolidate employees and responsibilities from a variety of regulatory bodies, including the Federal Reserve, the Federal Trade Commission, the Federal Deposit Insurance Corporation and the Department of Housing and Urban Development. The agency has responsibility for supervision and enforcement with respect to the laws over providers of consumer financial products and services that escaped regular Federal oversight. This agency is designed to protect families from unfair, deceptive, and abusive financial practices. The President urged Congress to give the consumer agency the same accountability and independence that the other banking agencies have and sufficient funding so it could ensure that powerful financial companies would comply with consumer laws.⁴

The central mission of the Consumer Financial Protection Bureau (CFPB) is to make markets for consumer financial products and services work for Americans — whether they are applying for a mortgage, choosing among credit cards, or using any number of other consumer financial products. Its objectives include giving consumers the information they need to understand the terms of their agreements with financial companies, and developing regulations and guidance that are clear and streamlined to enable providers of consumer financial products and services to follow the rules on their own.⁵

The literature and developments related to the Consumer Financial Protection Bureau (CFPB) are rapidly evolving. [See APPENDIX, Consumer Financial Protection Bureau (CFPB) References, at http://www.aira.org/pdf/journal/appx_cfpb.pdf.] The enactment of the Consumer Financial Protection Bureau results in major changes in the requirements imposed on the regulated parties. This has resulted in considerable doubt and confusion on the part of those parties and the regulators and legislators should proceed with caution. [See APPENDIX]. See for example, only see PRIVATE CAPITAL-A Case Study: Mortgage Banking Author: LaMalfa, Tom; Word Count: 4260; Loaded Date: 11/08/2012; 10/1/12 MORTBKG 62 2012 WLNR 23818216.

Federal Preemption of State Consumer Protections and Prerequisites to Foreclosure

Congress established the Consumer Financial Protection Bureau ("CFPB") to protect consumers by carrying out *Federal* consumer protections in mortgages and other financial laws, and that is the topic covered in this article. However, all states also have their own state laws and requirements protecting consumers in mortgages and other financial matters. Relevant state prerequisites to foreclosure are covered in Chapter 15 "Prerequisites to Foreclosure" in Baxter Dunaway, *The Law of Distressed Real Estate* (Thomson/West 1984-2013). As a consequence of this dual federal and state system of regulation, not all consumer protection state laws and regulations concerning residential mortgage transactions apply to all lenders or are enforceable as written because the state law may have been wholly or partially preempted by the federal law.⁶ Federal

¹ A detailed Appendix of Consumer Financial Protection Bureau references for this article is available online at < http://www.aira.org/pdf/journal/ appx_cfpb.pdf>

² Dodd– Frank Wall Street Reform and Consumer Protection ActPub.L. 111–203, July 21, 2010, 124 Stat. 1376. For text of Act see page 124 Stat. 1376;Statement by President of the United States 2010 U.S.C.C.A.N. S26, 2010 WL 4068938 (Leg.Hist.); Arthur E. Wilmarth, Jr., the Financial Services Industry's Misguided Quest to Undermine the Consumer Financial Protection Bureau, 31 Rev. Banking & Fin. L. 881, Spring 2012.

³ See the Website for the Consumer Financial Protection Bureau <www.consumerfinance.gov>.

⁴ Ibid.

⁵ Ibid

⁶ See Jared Elosta, Dynamic Federalism and Consumer Financial Protection:

preemption of a state law is not clear cut when reviewing state laws or regulations.⁷ This determination has been made difficult by the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), PL 111-203, July 21, 2010, 124 Stat. 1376 (H.R. 4173). The Dodd-Frank Act has scaled back federal preemption significantly, particularly with respect to federal depository institutions and their subsidiaries and affiliates. One provision of the Dodd-Frank Act that will have a wide-ranging impact on consumer financial services is the creation of the Consumer Financial Protection Bureau ("CFPB") as an independent bureau within the Federal Reserve System. The consumer protection functions of the federal agencies that are charged with consumer financial protection responsibilities were transferred to the CFPB as of July 21, 2011 (one year from enactment of the Dodd-Frank Act). Most of the federal laws concerning consumer protection with regard to financial products and services have been amended to provide for enforcement of these laws by the CFPB. In addition, the CFPB has rulemaking authority for these laws and sole or shared supervisory authority over certain depository financial institutions (and their subsidiaries and affiliates) and nonbank financial institutions.8

State consumer financial laws are preempted, only if—in accordance with the legal standard for preemption in the decision of the Supreme Court of the United States in Barnett Bank of Marion County, N. A. v. Nelson, Florida Insurance Commissioner, et al., 517 U.S. 25 (1996)—the State consumer financial law prevents or significantly interferes with the exercise by the national bank of its powers; and any preemption determination under this subparagraph may be made by a court, or by regulation or order of the Comptroller of the Currency on a case-by-case basis, in accordance with applicable law.⁹

To search for state law and regulations which may or may not be preempted by federal law, the Westlaw state Database Name is: Residential Mortgage Lending - State Regulation Manuals, and the Database Identifier for all states is RML-SRALL. For example, California database coverage is in RML-SRALL and is also in Residential Mortgage Lending: State Regulation Manual-West, Database Identifier: RML-SRW. See also, A.S. Pratt & Sons: Pratt's State Regulation of Second Mortgages and Home Equity Loans (Combined) (SMHEL) and A.S. Pratt & Sons: Pratt's Mortgage Lending Compliance with Federal and State Guidance (MTGLNDC).

How the Dodd-Frank Act Changes the Preemption Debate, North Carolina Law Review, 89 NCLR 1273, 1290, May, 2011. ("Addressing the concerns of one side of the preemption debate, the extensive power of the CFPB and its potential to be an effective federal regulator should satisfy consumer protection advocates and state attorneys general who have felt compelled to act to fill the gaps created by weak federal regulation.")

- 7 Id. Jared Elosta, Dynamic Federalism and Consumer Financial Protection:
 How the Dodd-Frank Act Changes the Preemption Debate, North Carolina
 Law Review, 89 NCLR 1273, 1290, May, 2011. See, for example, Westlaw
 database All (RML-SRALL) RML-SRSCN, Negroni and Kromer, Residential
 Mortgage Lending: Brokers, Federal Regulation of Mortgage Brokers §
 1:1 description of Westlaw database (Residential Mortgage Lending-State
 Regulation Manual South Central [for the south central group of states].
- 8 See Jared Elosta, Dynamic Federalism and Consumer Financial Protection: How the Dodd-Frank Act Changes the Preemption Debate, North Carolina Law Review, 89 NCLR 1273, 1290, May, 2011. For this discussion of preemption, see Westlaw database, Negroni and Kromer, Residential Mortgage Lending: Brokers, Federal Regulation of Mortgage Brokers § 1:1, RML-SRW, RML-SRW FPML § 1:1.
- 9 Kathleen C. Engel, Patricia A. McCoy, Banking & Financial Services Policy Report March, 2012 Federal Preemption and Consumer Financial Protection: past and Future, 31 No. 3 Banking & Fin. Services Pol'y Rep. 25.

Core Functions of the CFPB

Congress established the CFPB to protect consumers by carrying out Federal consumer financial laws. Among other things, the CFPB:¹⁰

- Conducts rule-making, supervision, and enforcement for Federal consumer financial protection laws
- Restricts unfair, deceptive, or abusive acts or practices
- Takes consumer complaints
- Promotes financial education
- Researches consumer behavior
- Monitors financial markets for new risks to consumers
- Enforces laws that outlaw discrimination and other unfair treatment in consumer finance.¹¹

CFPB Supervision and Examination Manual

The Bureau's Supervision and Examination Manual is a guide to how CFPB will supervise and examine consumer financial service providers under CFPB jurisdiction for compliance with Federal consumer financial law. The current version was issued on October 31, 2012. 12

Summary of Final Mortgage Servicing Rules

The CFPB (Bureau) on January 26, 2013 released on its website <www.consumerfinance.gov> the rules to implement laws to protect consumers from detrimental actions by mortgage servicers and to provide consumers with better tools and information when dealing with mortgage servicers. The rules will take effect on January 10, 2014. The servicing rules are set forth in two notices, one to amend Regulation Z, which implements the Truth in Lending Act, and one to amend Regulation X, which implements the Real Estate Settlement Procedures Act. The rules cover nine major topics and implement certain provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) that relate to mortgage servicing. ¹³

Background of Servicing Industry

The mortgage servicing industry was built to handle large volumes of loans for which only limited service was required. In the wake of the financial crisis, the number of distressed borrowers skyrocketed and the servicing industry was unable to keep up. As a result, an increased number of borrowers suffered substantial harm. The Dodd-Frank Act imposed new requirements on servicers and gave the Bureau the authority to both implement the new requirements and also to adopt additional rules to protect consumers. The Bureau is exercising that authority to improve the information consumers receive from their servicers, enhance the protections available to consumers to address servicer errors, and to establish some baseline servicing requirements that will provide

- 10 The Website for the Consumer Financial Protection Bureau is <www.consumerfinance.gov>.
- 11 See the Website for the Consumer Financial Protection Bureau <www.consumerfinance.gov>.
- 12 *Ibid*.
- 13 Ibid. For California, see also, Lois M. Jacobs, Heather E. Stern, Rights in Foreclosure, Los Angeles Lawyer, 35-JAN LALAW 24, January, 2013 (To Protect Homeowners Facing Foreclosure, the National Mortgage Settlement and Homeowner's Bill of Rights Impose New Standards on Mortgage Servicers). For Illinois see also Mary Ellen Podmolik, New rules to govern Illinois foreclosures, 2/22/13 Chi. Trib., 2013 WLNR 4515010 ("The Illinois Supreme Court is expected on Friday to announce new rules governing mortgage foreclosures that will require lenders to prove to judges that they have exhausted all efforts to help a borrower before seeking a foreclosure judgment against the homeowner.")

additional protections for consumers who have fallen behind on their mortgage payments.

The final rules include a number of exemptions and other adjustments for small servicers, defined as servicers that service 5,000 or fewer mortgage loans and service only mortgage loans that they or an affiliate originated or own. This definition covers substantially all of the community banks and credit unions that are involved in servicing mortgages. These exceptions and adjustments should help reduce burdens for these institutions that have strong consumer service safeguards already built into their business models.

Summary of the Final Rules¹⁴

The final rules cover nine major topics, which are summarized below.

- 1. Periodic billing statements—Creditors, assignees, and servicers must provide a periodic statement for each billing cycle containing, among other things, information on payments currently due and previously made, fees imposed, transaction activity, application of past payments, contact information for the servicer and housing counselors, and, where applicable, information regarding delinquencies. These statements must meet the timing, form, and content requirements provided in the rule. The rule contains sample forms that may be used. The periodic statement requirement generally does not apply to fixed-rate loans if the servicer provides a coupon book, so long as the coupon book contains certain information specified in the rule and certain other information specified in the rule is made available to the consumer. The rule also includes an exemption for small servicers as defined above.
- 2. Interest-rate adjustment notices for ARMs—Creditors, assignees, and servicers must provide a consumer whose mortgage has an adjustable rate with a notice between 210 and 240 days prior to the first payment due after the rate first adjusts. This notice may contain an estimate of the new rate and new payment. Creditors, assignees, and servicers also must provide a notice between 60 and 120 days before payment at a new level is due when a rate adjustment causes the payment to change. The current annual notice that must be provided for ARMs for which the interest rate, but not the payment, has changed over the course of the year is no longer required. The rule contains model and sample forms that servicers may use.
- 3. Prompt payment crediting and payoff statements—Servicers must promptly credit periodic payments from borrowers as of the day of receipt. A periodic payment consists of principal, interest, and escrow (if applicable). If a servicer receives a payment that is less than the amount due for a periodic payment, the payment may be held in a suspense account. When the amount in the suspense account covers a periodic payment, the servicer must apply the funds to the consumer's account. In addition, creditors, assignees, and servicers must provide an accurate payoff balance to a consumer no later than seven business days after receipt of a written request from the borrower for such information.
- **4. Force-placed insurance**—Servicers are prohibited from charging a borrower for force-placed insurance coverage unless the servicer has a reasonable basis to believe the borrower has failed to maintain hazard insurance and has provided required notices. An initial notice must be sent to
- 14 Source, See the Website for the Consumer Financial Protection Bureau www.consumerfinance.gov>.

- the borrower at least 45 days before charging the borrower for force-placed insurance coverage, and a second reminder notice must be sent no earlier than 30 days after the first notice and at least 15 days before charging the borrower for force-placed insurance coverage. The rule contains model forms that servicers may use. If a borrower provides proof of hazard insurance coverage, the servicer must cancel any force-placed insurance policy and refund any premiums paid for overlapping periods in which the borrower's coverage was in place. The rule also provides that charges related to forceplaced insurance (other than those subject to State regulation as the business of insurance or authorized by Federal law for flood insurance) must be for a service that was actually performed and must bear a reasonable relationship to the servicer's cost of providing the service. Where the borrower has an escrow account for the payment of hazard insurance premiums, the servicer is prohibited from obtaining forceplace insurance where the servicer can continue the borrower's homeowner insurance, even if the servicer needs to advance funds to the borrower's escrow account to do so. The rule against obtaining force-placed insurance in cases in which hazard insurance may be maintained through an escrow account exempts small servicers as defined above so long as any force-placed insurance purchased by the small servicer is less expensive to a borrower than the amount of any disbursement the servicer would have made to maintain hazard insurance coverage.
- Error resolution and information requests—Servicers are required to meet certain procedural requirements for responding to written information requests or complaints of errors. The rule requires servicers to comply with the error resolution procedures for certain listed errors as well as any error relating to the servicing of a mortgage loan. Servicers may designate a specific address for borrowers to use. Servicers generally are required to acknowledge the request or notice of error within five days. Servicers also generally are required to correct the error asserted by the borrower and provide the borrower written notification of the correction, or to conduct an investigation and provide the borrower written notification that no error occurred, within 30 to 45 days. Further, within a similar amount of time, servicers generally are required to acknowledge borrower written requests for information and either provide the information or explain why the information is not available.
- General servicing policies, procedures, and requirements—Servicers are required to establish policies and procedures reasonably designed to achieve objectives specified in the rule. The reasonableness of a servicer's policies and procedures takes into account the size, scope, and nature of the servicer's operations. Examples of the specified objectives include accessing and providing accurate and timely information to borrowers, investors, and courts; properly evaluating loss mitigation applications in accordance with the eligibility rules established by investors; facilitating oversight of, and compliance by, service providers; facilitating transfer of information during servicing transfers; and informing borrowers of the availability of written error resolution and information request procedures. In addition, servicers are required to maintain certain documents and information for each mortgage loan in a manner that enables the services to compile it into a servicing file within five days. This section includes an exemption for small servicers as defined above. The Bureau and the prudential regulators will be able to supervise servicers within their jurisdiction to

assure compliance with these requirements but there will not be a private right of action to enforce these provisions.

- 7. Early intervention with delinquent borrowers—Servicers must establish or make good faith efforts to establish live contact with borrowers by the 36th day of their delinquency and promptly inform such borrowers, where appropriate, that loss mitigation options may be available. In addition, a servicer must provide a borrower a written notice with information about loss mitigation options by the 45th day of a borrower's delinquency. The rule contains model language servicers may use for the written notice. This section includes an exemption for small servicers as defined above.
- Continuity of contact with delinquent borrowers-Servicers are required to maintain reasonable policies and procedures with respect to providing delinquent borrowers with access to personnel to assist them with loss mitigation options where applicable. The policies and procedures must be reasonably designed to ensure that a servicer assigns personnel to a delinquent borrower by the time a servicer provides such borrower with the written notice required by the early intervention requirements, but in any event, by the 45th day of a borrower's delinquency. These personnel should be accessible to the borrower by phone to assist the borrower in pursuing loss mitigation options, including advising the borrower on the status of any loss mitigation application and applicable timelines. The personnel should be able to access all of the information provided by the borrower to the servicer and provide that information, when appropriate, to those responsible for evaluating the borrower for loss mitigation options. This section includes an exemption for small servicers as defined above. The Bureau and the prudential regulators will be able to supervise servicers within their jurisdiction to assure compliance with these requirements but there will not be a private right of action to enforce these provisions.
- 9. Loss mitigation procedures—Servicers are required to follow specified loss mitigation procedures for a mortgage loan secured by a borrower's principal residence. If a borrower submits an application for a loss mitigation option, the servicer is generally required to acknowledge the receipt of the application in writing within five days and inform the borrower whether the application is complete and, if not, what information is needed to complete the application. The servicer is required to exercise reasonable diligence in obtaining documents and information to complete the application.

For a complete loss mitigation application received more than 37 days before a foreclosure sale, the servicer is required to evaluate the borrower, within 30 days, for all loss mitigation options for which the borrower may be eligible in accordance with the investor's eligibility rules, including both options that enable the borrower to retain the home (such as a loan modification) and non-retention options (such as a short sale). Servicers are free to follow "waterfalls" established by an investor to determine eligibility for particular loss mitigation options. The servicer must provide the borrower with a written decision, including an explanation of the reasons for denying the borrower for any loan modification option offered by an owner or assignee of a mortgage loan with any inputs used to make a net present value calculation to the extent such inputs were the basis for the denial. A borrower may appeal a denial of a loan modification program so long as the borrower's

complete loss mitigation application is received 90 days or more before a scheduled foreclosure sale.

The rule restricts "dual tracking," where a servicer is simultaneously evaluating a consumer for loan modifications or other alternatives at the same time that it prepares to foreclose on the property. Specifically, the rule prohibits a servicer from making the first notice or filing required for a foreclosure process until a mortgage loan account is more than 120 days delinquent. Even if a borrower is more than 120 days delinquent, if a borrower submits a complete application for a loss mitigation option before a servicer has made the first notice or filing required for a foreclosure process, a servicer may not start the foreclosure process unless (1) the servicer informs the borrower that the borrower is not eligible for any loss mitigation option (and any appeal has been exhausted), (2) a borrower rejects all loss mitigation offers, or (3) a borrower fails to comply with the terms of a loss mitigation option such as a trial modification.

If a borrower submits a complete application for a loss mitigation option after the foreclosure process has commenced but more than 37 days before a foreclosure sale, a servicer may not move for a foreclosure judgment or order of sale, or conduct a foreclosure sale, until one of the same three conditions has been satisfied. In all of these situations, the servicer is responsible for promptly instructing foreclosure counsel retained by the servicer not to proceed with filing for foreclosure judgment or order of sale, or to conduct a foreclosure sale, as applicable.

This section includes an exemption for small servicers as defined above. However, a small servicer is required to comply with two requirements: (1) a small servicer may not make the first notice or filing required for a foreclosure process unless a borrower is more than 120 days delinquent, and (2) a small servicer may not proceed to foreclosure judgment or order of sale, or conduct a foreclosure sale, if a borrower is performing pursuant to the terms of a loss mitigation agreement.

All of the provisions in the section relating to loss mitigation can be enforced by individuals. Additionally, the Bureau and the prudential regulators can also supervise servicers within their jurisdiction to assure compliance with these requirements.

Implementation

The effective date for both of these rules is January 10, 2014. The Bureau generally believes that the final rules should be made effective as soon as possible, and the Dodd-Frank Act in some cases provides no more than 12 months for implementation. However, the Bureau understands that the final rules will require revisions to software, staff training, and other changes. Some companies may also need to implement other new requirements under other parts of the Dodd-Frank Act. The Bureau will be working to help industry to achieve the implementation of these rules by the effective date.

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For an annotated list of references see:

APPENDIX: Consumer Financial Protection Bureau (CFPB) at:
http://www.aira.org/pdf/journal/appx_cfpb.pdf

Private Equity Operations Groups





Matthew Thompson, CIRA and Matt Tweedie
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There has been a significant rise in the number of portfolio operations groups in private equity over

recent years. Private Equity boomed in the 1980's and primarily relied on the use of financial engineering in leveraged buyouts to achieve the high returns that defined that era. As more leveraged buyout shops emerged, the competition for deals increased and returns subsided. In addition, in the post-credit crisis world it has been more challenging to obtain credit, and private equity funds have had to write larger equity checks than before which has also negatively impacted private equity returns.

In order to increase returns, private equity funds are left with either improving EBITDA or increasing their EBITDA exit multiples. Changing the EBITDA exit multiple is contingent upon timing and valuation expectations, which are not under the fund's control. Company valuations ebb and flow with economic cycles and how attractive the industry is at the time. However, improving EBITDA can be accomplished through operational improvements and can be an effective means of unlocking value. Ron Nayot, Managing Director at Diversis Capital believes that "The ability to effectuate change within a company is distinctly measurable in diligence and within the control of PE in-house operators. It can bring tangible run-rate EBITDA improvements quickly post-transaction."

The PrEQin Private Equity Quarterly Index indicates that some of the highest returns in private equity have been achieved by funds that invest in distressed situations. As distressed investments are typically in dire need of operational improvements, there is a role for professionals dedicated to operational enhancements.

Private equity funds with distressed investments as well as firms that invest with other strategies often use in-house operations teams to implement such improvements. Britt Terrell, Managing Director at Backbone Capital Advisors, describes the need for operating professionals, as "In most distressed situations, lenders will need heightened confirmation that an appropriately skilled, professional operations team can execute the modeled operational improvements, ideally with a track record that has demonstrated operations improvements."

UCLA Anderson School of Management professor Alfred Osborne, Ph.D. said "Private equity funds who have strong operating teams as part of their strategy to produce above normal returns have a distinct competitive advantage. Simple financial engineering is not enough. Investment firms that dig deep into a company's operations, and understand the business from top to bottom, will find sources of value. Doing so is a clear path to better margins and exit multiples."

What In-house Operations Teams Do

In-house operational teams perform a variety of functions, including:

- 1. Leading upfront due diligence of target investments
- 2. Implementing post-acquisition operational improvements on portfolio companies
- 3. Assisting with deal sourcing for new portfolio companies
- 4. Providing subject matter expertise in an industry or functional
- 5. Assuming management and/or board roles at portfolio companies

Private equity funds have implemented an array of different operations group models. These groups range along a spectrum from having no dedicated operations professionals all the way to assembling large, specialized in-house operations teams. Three broad groups emerge, as illustrated in the Exhibit below and on the following page.

EXHIBIT: OPERATIONAL MODEL SPECTRUM

No In-house Operations Group

- All diligence is done by deal professionals
- Rely solely on external advisors

No In-house Operations Group

- Hybrid approach where in-house deal and operations team perform work and hire external advisors as necessary
- Relatively flat group of generalists

No In-house Operations Group

- Large specialized group with niche roles
- Able to complete diligence and turnaround with limited external advisors

- 1. No dedicated in-house operations group. A former CEO or other individual with strong operational experience is put in place to implement a strategic plan and monitor company progress. Deal professionals work with third parties to manage and monitor portfolio companies. This approach tends to work better when the portfolio companies are relatively healthy and do not require major transformational improvements.
- 2. Small internal operations group. A small generalist team is hired, including executives, accountants, marketing specialists and strategists. These in-house teams may include one to ten in-house staff. The operations group can fill gaps and implement operational improvements. This is a hybrid approach that allows the small group of in-house portfolio operations staff to oversee third-party advisors.
- 3. Large in-house operations group. A large in-house operational team consisting of private equity fund employees is brought in to drive the operational plan. Funds with such an approach include KKR Capstone, Bain Capital, Cerberus and TPG. Their in-house operations teams have 20 + portfolio operations professionals who have strong operations expertise. These teams often have multiple levels of personnel (e.g. MD, VP and Associate) and access to a large bench of professionals to oversee diligence and the turnaround of portfolio companies. In some circumstances they will hire third-party advisors and executives for specific assignments.

Some of the pros and cons of private equity funds using in-house operational teams include:

Pros

- In-house operations teams are typically less expensive per hour than hiring external consultants which can result in cost savings for the private equity fund.
- The in-house team will have a much stronger understanding of the private equity fund's investment approach and will have worked together repeatedly. This results in increased operational efficiencies.
- The in-house team is more in-tune with the private equity deal professionals and therefore requires less monitoring by the private equity fund.
- The team's incentives are typically more aligned with fund performance. An in-house team will work to maximize the fund's return, while a third-party advisor may be more short-sighted (e.g. focus on

- short-term deal closing rather than the fund's long-term returns).
- The individuals hired into these in-house operations roles have different backgrounds and career experiences than traditional private equity professional. This results in a team with a more diverse skill set and helps promote a more rigorous deal evaluation process.
- The teams can be assembled very quickly. For example, a team can be formed internally over a weekend, rather than taking several weeks to source external consultant assistance (e.g. project scoping, engagement letters, etc).

Cons

- In-house operations team members may not have the precise industry expertise or specialization of a niche external consultant.
- There is potential for compensation conflicts with both the portfolio company as well as deal professionals (e.g. in some cases inhouse operational teams charge portfolio companies directly).
- In-house operations teams are a significant fixed cost for the fund, which can be problematic as deal flow subsides.

These private equity operations groups are very relevant to the AIRA community as they are often looking for diligence and turnaround support. These groups often look for people with strong restructuring and consulting backgrounds as key hires to implement their operational plans. They hire MBAs, consultants and in some cases former investment bankers that have more of an operational focus and functional experience including IT, HR, tax, legal and supply chain. Many of these in-house professionals have prior C-level experience within operating businesses.

As the economy improves, it is unclear whether private equity funds will continue to expand the size of internal operations groups or if the cycle will shift back to keeping smaller in-house groups that leverage larger teams of external advisors.

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Lehman Bankruptcy Court Overrules UST Fee Objection and Reaffirms Confirmed Plan Provision



Leah Eisenberg *Arent Fox LLP*

Plan provision provided for the consensual payment of reasonable individual committee members' professional fees and expenses, including counsel to indenture trustees.

In a recent contested matter in the historic cases, Lehman Brothers Holdings Inc., et al. (the "Debtors"), Case No. 08-13555 (Peck, I.), pending in the United States Bankruptcy Court for the Southern District of New York, the Bankruptcy Court overruled a challenge by the United States Trustee for Region 2 (the "UST") to the rights of individual members of the official committee of unsecured creditors appointed in the cases (the "Committee" or the "Committee Members," as applicable) to be paid reasonable compensation for legal services rendered to the Committee Members by their own attorneys, which fees, subject to a finding of reasonableness, were to be consensually paid by the Debtors under the Debtors' confirmed Chapter 11 plan of reorganization (the "Plan"). The Bankruptcy Court reached its conclusion by focusing on those distinct sections of the Bankruptcy Code that supported the use of flexible and creative plan drafting and negotiation to authorize consensual distributions of cash from the Debtors' estates to pay for Committee Members' individual counsel fees, despite the administrative expense standards imposed under Section 503(b) of the Bankruptcy Code.

Background

The Bankruptcy Court began its discussion by highlighting the fact that the success of these Chapter 11 cases was due to, in part, professional excellence, creativity and negotiation by all the parties involved, including the Committee and its individual members. The Committee Members included two indenture trustees, which, discussed below, implicated Section 503(b)(3)(D) of the Bankruptcy Code, which requires a showing of a substantial contribution in order for indenture trustees to be reimbursed for professional fees with administrative expense priority. As the Bankruptcy Court ultimately concluded that the Committee Members, including the two indenture trustees, were entitled to receive reimbursement for professional fees under the Plan and Section 1129(a)(4), provided such fees met the reasonableness test under such Section, it held it did not need to determine whether the indenture trustees satisfied Section 503(b)(3)(D) of the Bankruptcy Code.

Section 6.7 of the Plan contained specific language that secured the right of the Committee Members to receive payment for reasonable fees and expenses, including counsel fees, in connection with the Chapter 11 cases. Originally, the UST filed an objection to confirmation of the Plan, arguing Section 6.7 violated the Bankruptcy Code and that only Section 503(b) provided the Bankruptcy Court with the standard for evaluating fees and expenses of the Committee Members. The UST subsequently withdrew this objection upon a reservation of rights.

After the Plan was confirmed, the Committee Members filed an omnibus application for payment of fees and reimbursement of expenses (the "Application"), seeking support under Section 1129(a)(4) and alternatively, under Sections 503(b)(3)(D) and 503(b) (4) of the Bankruptcy Code. The UST filed an omnibus objection to the Application, raising similar arguments as were made in the UST's objection to confirmation of the Plan, including that the indenture trustees on the committee failed to show a substantial contribution in these cases. Further pleadings arguing these issues were filed by the parties.

The Bankruptcy Court's Discussion and Ruling

The Bankruptcy Court began its discussion by setting forth the structure of Section 503(b) of the Bankruptcy Code and the basis for allowing administrative expense priority for professional fees and expenses. In doing so, the Bankruptcy Court also emphasized that Section 503(b) was not the sole means by which to provide support for reimbursement of such fees and expenses. The Bankruptcy Court went on to discuss Section 1123(b)(6) of the Bankruptcy Code, which is a catch-all provision that allows a plan to include "any other appropriate provision not inconsistent with the applicable provisions of the [Bankruptcy Code]." 11 U.S.C. § 1123(b)(6). This catch-all provision was viewed by the Bankruptcy Court as a great tool by which parties involved in plan negotiations can provide creative and flexible provisions in a Chapter 11 plan, provided such provisions do not violate applicable bankruptcy law, and viewed Section 6.7 of the Plan as an example of such creative drafting. Further, by invoking Section 1129(a)(4) of the Bankruptcy Code into Section 6.7 (by providing a mechanism by which the Bankruptcy Court maintained the ability to review all payments made under the Plan), the Bankruptcy Court concluded Section 6.7 of the Plan fit within the proper boundaries of Section 1123(b)(6) and was not inconsistent with other bankruptcy law, including those provisions in Section 503(b) governing the allowance of administrative expenses.

Analysis

The Bankruptcy Court was not troubled with the fact that the Plan provided for the consensual payment of the Committee Members' professional fees and expenses, as opposed to having such expenses approved as part of the process of allowing administrative expenses under the Bankruptcy Code. The Bankruptcy Court found that such approach did not, as the UST attempted to argue, improperly circumvent the Bankruptcy Code. Moreover, the fact that the proposed payment of these professional fees was not expressly supported by Section 503(b), did not persuade the Bankruptcy Court to conclude that such payments would be inconsistent with Section 503(b) of the Bankruptcy Code. While the UST advanced a restrictive reading of 503(b) by arguing the administrative claim process was the exclusive means by which a committee member could ever be entitled to receive compensation for its own individual legal fees, the Bankruptcy Court disagreed and found that (a) Sections 1123(b)(6) and 1129(a)(4) provide the

appropriate means by which a plan can propose payment rights akin to here, so long as such payments are reasonable and do not violate other Bankruptcy Code Sections, and (b) Section 503(b) and the provisions that govern the allowance of administrative claims do not control the plan process and are not inconsistent with the flexible plan-drafting and plan-negotiation provisions in the Bankruptcy Code.

The Bankruptcy Court found similar support in Judge Gerber's decision in *In re Adelphia Commc'ns Corp.*, 441 B.R. 6 (Bankr. S.D.N.Y. 2010) ("*Adelphia*"). In *Adelphia*, 14 ad hoc committees and certain individual creditors sought reimbursement for professional fees pursuant to a plan provision similar to Section 6.7 of the Plan, which, like here, was a product of a global resolution, whereby the applicants submitted fee applications and asserted such applications were only subject to a reasonableness review under Section 1129(a)(4) of the Bankruptcy Code, without a showing of compliance with Sections 503(b) or (4).

In the Chapter 11 cases of *In re Washington Mutual, Inc., et al*, Case No. 08-12229 (MFW), pending in the Bankruptcy Court for the District of Delaware, the members of the creditors' committee — all indentures trustees — established a consensual protocol with the debtors whereby each indenture trustee agreed to file applications with the court seeking to partially liquidate and allow their proofs of claim for fees and expenses arising under their respective indenture documents. The Chapter 11 plan in these cases implemented a global settlement among significant parties and contained similar provisions relating to the payment of reasonable indenture trustee fees and expenses on the plan's effective date pursuant to Section 1129(a)(4), without a showing of compliance with Sections 503(b) or (4).

In reaching his conclusion, the Bankruptcy Court highlighted the specific facts of these complex and large cases, where (a) the Plan was the product of intense negotiations that resulted in a global settlement, the absence of which would have resulted in a "monumental and unmanageable confirmation battle"; and (b) the provisions under the Plan providing for the consensual payment of Committee Member counsel fees became an element of this global settlement that all creditors voted on and supported. Indeed, the Bankruptcy Court recognized that the language in Section 6.7 of the Plan was designed to provide the Committee Members with greater certainty that they would receive payment for their individual counsel fees in light of the Bankruptcy Code's limitations on whether such fees could be allowable as administrative expenses.

Conclusion

Based upon the Bankruptcy Court's decision, in large and complex cases such as here, where significant creditors, including members of a committee and/or indenture trustees, are among the major parties that contributed to a successful plan confirmation process, parties may utilize the creative and flexible aspects of bankruptcy negotiation and plan drafting to achieve a global settlement, implement such settlement into a plan and provide for alternative methods of payment of creditor professional fees, so long as (a) such fees are reasonable, (b) the underlying plan provisions do not violate other Bankruptcy Code provisions, and (c) creditors have an opportunity to vote to accept or reject the plan and overwhelmingly vote to accept such plan.

As part of the plan negotiation process, indenture trustees often give consideration to ensure that the plan provides for payment of the fees and expenses of the indenture trustee, including counsel fees, rather than using the payment priority provisions of the indenture, also known as the charging lien. Obviously, there are risks, both legal and business, in making such a decision but what is clear is that there is now strong authority to have such payments made under a confirmed plan.

Leah Eisenberg is a partner in the Bankruptcy and Financial Restructuring Practice of Arent Fox LLP in New York. She focuses on corporate reorganization, bankruptcy and inter-creditor issues and corporate trust matters and represents committees of unsecured creditors, indenture trustees, secured creditors, debtor-in-possession lenders, acquirors, unsecured creditors, bondholder and noteholder groups, equity holders, investors, creditor trustees, liquidation trustees, plan administrators, and disbursing agents and other entities in bankruptcy reorganization and liquidation proceedings. Leah also is a member of the firm's Steering Committee for the firm's Women's Leadership Development Initiative.

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Robert A. Wiedemer is a Managing Director with Absolute Investment Management, an individual money management firm with over a quarter billion dollars in assets. He wrote the landmark book that predicted the downturn in the economy in 2006, *America's Bubble Economy*, published by John Wiley. Kiplinger's chose it as one of the best business books of 2006. Mr. Wiedemer's following book, *Aftershock*, was published by John Wiley in November 2009. It was chosen by Smart Money magazine as one of the five best investment books of 2009. *Aftershock Second Edition* was published in August 2011 and became a New York Times and Wall Street Journal Bestseller. Both editions have sold over 700,000 copies. His fourth book, *The Aftershock Investor*, was released in September 2012 and is a Wall Street Journal Bestseller. He is a frequent commentator on CNBC and Fox Business News.



Lynn J. Osmond – President & CEO, Chicago Architecture Foundation

Lynn Osmond assumed the position of President and CEO of the Chicago Architecture Foundation (CAF) in 1996. She is responsible for overseeing CAF's comprehensive program of architecture tours, exhibitions, public programs, including lectures and special events, youth and adult education programs. With Osmond's strong leadership in organizational development, CAF has realized 300% in organizational growth, has consistently ranked among the top ten Chicago cultural institutions, and has grown its audience to more than half a million visitors. CAF's docent program has also thrived during Osmond's tenure, becoming internationally recognized as the leading program of its kind in the world. Osmond also spearheaded the launching of the Association of Architecture Organizations and the Architecture + Design Education Network.



Grant Achatz - Chef and Restaurateur

Grant Achatz grew up in the restaurant industry where both his parents and grandparents were restaurateurs. He realized early on that he wanted to become a chef, and upon graduating from high school he immediately enrolled at the Culinary Institute of America. Excelling at the Culinary Institute, Achatz graduated and began working at the famous French Laundry in Napa Valley. After two years of working closely with Thomas Keller, he became sous chef. In 2001, he accepted the Executive Chef position at Trio, a four-star restaurant outside of Chicago.

Known worldwide as a leader of the forward-thinking movement, Achatz realized a lifelong dream by opening his restaurant Alinea in Chicago in May 2005. Under Chef Achatz's leadership, Alinea has received worldwide attention for its hypermodern, emotional approach to dining. In October 2006, Ruth Reichl of *Gourmet* magazine declared Alinea the "Best Restaurant in America" and in 2011 the restaurant received 3 Michelin stars. In April 2011, Achatz opened his next restaurant, Aviary Cocktails, in the West Loop area of Chicago. That same year, Achatz released his memoir entitled "Life, on the Line."



Camisha L. Simmons, Esq. - Fulbright & Jaworski L.L.P.

Camisha, a member of the Bankruptcy & Insolvency practice group of Fulbright & Jaworski L.L.P., focuses her practice on the representation of debtors and creditors in complex restructuring and bankruptcy matters. Camisha is in high demand as a speaker and has authored numerous published articles on various bankruptcy topics, including her most recent article titled "Code Doesn't Address Health Care Privacy Concerns," published in the Dow Jones Daily Bankruptcy Review. Since 2007, she has served on the Editorial Board of the American Bankruptcy Institute Journal where she currently serves as Coordinating Editor of the Journal's "News at 11" column. She holds a J.D., magna cum laude and an M.B.A. from Texas Tech University, an M.Ed. from the University of Maryland, College Park and a B.B.A. from Campbell University. Prior to beginning her legal career, she served on active duty in the United States Army from 1999 to 2003.

29th Annual Bankruptcy & Restructuring Conference Social Activities

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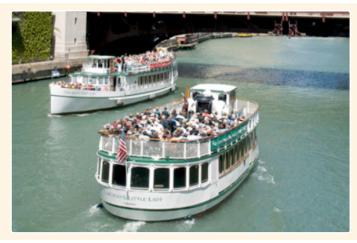
Golf Sponsored by AlixPartners, LLP
Drink Cart Sponsored by Burr & Forman LLP
Thursday, 12:15 pm
Price: \$150



Architecture River Cruise

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Sponsored by Arent Fox LLP
Thursday, 1:30 pm
Price: \$60



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Thursday, 12:30 pm Price: \$140

16

Baseball Outing: White Sox v Athletics

There's no better way to kick-off your summer than with a baseball outing and a matchup between the Chicago White Sox and the Oakland Athletics! Enjoy a pre-game patio picnic at U.S. Cellular Field and a fireworks show after the game!

Sponsored by Hammond Hanlon Camp LLC Friday, 5:30 pm Price: \$120

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BANKRUPTCY TAXES

The following articles were written by:



D. Joshua Elliott, CIRA, CPA *Dixon Hughes Goodman LLP*

\$374M REASONS TO ARGUE OVER A REFUND

In *Claybrook v. U.S.'*, the United States Court of Federal Claims ruled that the Federal Deposit Insurance Corporation ("FDIC") had authority separate from

a Chapter 7 bankruptcy trustee to file returns on behalf of the debtor where the debtor is a financial institution in receivership. The case is complex with enough citations, banking terminology and rabbit trails to induce severe narcolepsy – however, the facts and concepts are pretty basic and interesting.

Montague Claybrook was the Court-appointed trustee in the Chapter 7 liquidation of Downey Financial Corporation ("Parent"). Prior to its bankruptcy, Parent served primarily as a holding company for Downey Savings and Loan Association ("Sub"). Outside of Sub operations, Parent had nominal if any activity. In late 2008, the FDIC stepped in as receiver on the failing banking operations. The FDIC subsequently sold the banking assets to an unrelated bank, limiting the new buyer's losses from the Sub assets but retained the rights to certain assets, including "the rights to any and all tax refunds to which Sub is entitled."

Parent and Sub filed tax returns as part of Parent's consolidated tax group. Following the FDIC's sale of Sub's banking assets, the trustee filed a consolidated tax return seeking approximately \$374M in federal income tax refunds under either one of two theories – that Parent has a loss on the devaluation of its stock investment in Sub or that Parent incurred an NOL. Essentially all of the consolidated net operating losses generating the refunds resulted from Sub's losses. However, the refund applications were filed in the name of Parent, as the parent of the consolidated tax group. Partially at issue was whether the refunds were the result of Parent's stock loss or Sub's NOLs.

Shortly after the trustee filed refund applications on behalf of Parent, the FDIC, citing the oft-used IRC §6402(k) and Treas. Reg. §1.6402-7, filed "alternative" refund applications using the second theory (that the losses were Sub's NOLs) in order to protect its position. Essentially, a battle ensued between the FDIC and the trustee as to who was entitled to the income tax refunds.

After extended shucking and jiving by both parties, the Court essentially ruled for the FDIC. In its ruling, the Court found it was the right of the consolidated group and not the right of the parent

1 No. 10-734T (Fed. Cl. 4/18/12):

alone to seek refunds for the overpayment of taxes. Additionally, to deny the FDIC the right in the instant case to file alternate tax returns and protect the refund would mean that Congress created a means for the FDIC to file a tax return without an ability to enforce it in federal court.

While the case cites some IRC sections that will likely be unused outside a very narrow fact pattern, the case does highlight that the Court will be cautious when multiple parties may have rights to receive all or some of a consolidated group's income tax refunds.

NEW YORK STATE BAR ASSOCIATION IS CERTAIN ON UNCERTAIN LIABILITES

Most of us are familiar with the basic tax rules related to cancellation of indebtedness. Generally, a taxpayer has income to the extent that it accedes to economic wealth, such as in the case where its debt is either forgiven or exchanged for value less than face ("COD income"). Under IRC §108, however, gross income for tax purposes excludes COD income if, among other things, the debt is either discharged in bankruptcy (fully excludable) or if the debt is discharged while the taxpayer is insolvent (excludable to the extent of insolvency). A taxpayer is generally insolvent to the extent its liabilities exceed the fair market value of its assets immediately before the discharge.²

The FMV of assets can be calculated with various valuation techniques. But how does one value liabilities? What constitutes a liability? It is not defined in IRC §108. If a liability is not directly supported by a note or an invoice, how do you determine the value? What about contingent liabilities – should they be included?

On November 22, 2012, the Tax Section of the New York State Bar Association ("NYSBA") submitted a letter to the Internal Revenue Service and the Department of Treasury sharing their comments on the inclusion of contingent liabilities in the calculation of insolvency.

The letter traces the background on the promulgation of IRC §61 for the inclusion of discharged debt in gross income and of IRC §108 (codified in 1980) on the exclusion from income to the extent of solvency. In a 1983 private letter ruling, the IRS ruled that there is no authority to include contingent liabilities in calculating insolvency.³ A variety of cases, Field Service Advices and Revenue Rulings through the 1980's and 1990's continued the general IRS position that contingent liabilities should be excluded from the insolvency calculation. Then, in 1999, a Ninth Circuit decision narrowed focused on whether contingent liabilities should be included in the insolvency calculation and seemingly proctored a new test for determining whether they should be included.

² IRC §108(d)(3).

³ PLR 8348001 (8/18/1983).

In *Merkel v. Commissioner*⁴, two husband-and-wife couples (the Merkels and the Hepburns) were partners in a partnership that realized COD income. Separately, Messrs. Merkel and Hepburn were officers in an unrelated corporation. They had personally guaranteed the bank debt of the corporation. They were also secondarily liability for a sales tax claim filed against the corporation. Both of these liabilities were contingent to the Merkels and Hepburns personally. Note that for IRC §108 purposes, insolvency is determined at the partner and not the partnership level.⁵ So for purposes of determining whether they could exclude some or all of the COD income flowing out of the partnership, the couples included the contingent liabilities from the corporation in their personal insolvency calculations. The IRS disagreed and the parties entered the hallowed halls of justice.

The IRS argued that just as contingent liabilities are excluded from the balance sheet of a company (and instead are included solely in the footnotes – an argument which this author does not advocate since certain contingent liabilities may be recognizable on the balance sheet in GAAP financial statements). The taxpayers argued that a common-sense analysis of "liabilities" should include all liabilities to which the taxpayers are subject. After consideration, the Court established a new standard – that contingent liabilities are fully includible only if it is more probable than not that a taxpayer will have to pay them. If the contingent liabilities are not more probable than not of requiring payment, then none of the liability is included in a taxpayer's calculation of insolvency.

The Ninth Circuit upheld the Tax Courts' opinion. However, in his dissent, Judge O'Scannlain pointed to the harsh disparity between a 49% probable contingent obligor including no liabilities in his insolvency calculation and a 51% probable contingent obligor including all of the liability.

The NYSBA amplified the dissenting opinion, noting that *Merkel* approach "does not accurately reflect the true economic impact of a contingent liability on a taxpayer's net worth." The NYSBA letter offered several recommendations (further broken out for ease):

- Include contingent liabilities at their relative liability probability (e.g., if 49% probable, include 49%). For contingent liabilities with less than a 20% probability of payment, exclude 100%. For contingent liabilities with greater than an 80% probability of payment, include 100%.
- Use the existing rules of Treas. Reg. §1.752-7(b)(3)(ii) to determine the FMV of all contingent liabilities. Note that this Regulation provides a framework for the value of liabilities used in partner contribution and basis calculations. It generally quantifies a liability as the amount of cash a willing assignor would pay to a willing assignee to assume said liability.
- 4 109 T.C. 463 (1997), affirmed, 192 F.3d 844 (9th Cir. 1999).
- 5 IRC §108(d)(6).

- Adopt the definitions of "obligation", "liability" and "§1.752-7 liability" under the §752 Regulations as the definitions of "obligation", "fixed liabilities" and "contingent liabilities", respectively, for purposes of §108.
- Adopt an optional safe-harbor method for valuing contingent liabilities in the insolvency calculation where corporate shareholders discharge debt by issuing stock (which occurs in many out-of-court restructurings).

In addition to providing the above summary recommendations, NYSBA letter offers an in-depth analysis of multiple alternatives in valuing contingent liabilities in the insolvency calculation. For any professionals restructuring a debtor with contingent liabilities, the letter is a recommended primer.

D. Joshua Elliott, CPA is a tax partner in the Greenville, SC office of Dixon Hughes Goodman LLP. Contact him at joshua.elliott@dhqllp.com.

The following articles were written by:



Forrest Lewis, CPA *Section Editor*

IRS DESCRIBES TAX TREATMENT OF INDIVIDUALS UNDER MORTGAGE REDUCTION PROGRAMS

The Internal Revenue Service has clarified the income tax treatment of the various federal and state mortgage relief

programs under which individuals have their mortgage balances reduced and part or all of the reduction is subsidized by state or federal funds. The primary federal programs are the Department of Housing and Urban Development's Home Affordable Modification Program-Principal Reduction Alternative (HAMP-PRA) and the Emergency Homeowners Loan Program. In a series of rulings, the IRS has prescribed how individuals are to report the tax consequences of their participation in the various programs and how the mortgage servicers are to report payments made by HUD and by the borrowers [Notice 2013-7, Rev. Proc. 2013-16, etc.]

Interest Reporting

Interest expense collected by a mortgage servicer is reported to the payor on Form 1098 annually. One of the problems with delinquent mortgage loans is computing the amount of interest (and property taxes if applicable) actually paid when not all principal payments were made. Under the rulings, IRS allows a taxpayer to deduct the lesser of the payments made for the year or the interest expense, property taxes and mortgage insurance premiums reported on the 1098, all of which are deductible. In these programs, all payments by the borrower are considered first to go to interest, property taxes and mortgage insurance premiums, if applicable.

Principal Reductions Made Under the Assistance Programs

The new IRS rules are best illustrated by examining treatment of HAMP-PRA, which is the most complex program addressed by IRS. That program provides for a principal reduction determined under HUD formulas which is essentially "earned" by the borrower timely making the reduced monthly payments specified in the program over a three year period. Some or all of the reduction can be added back to the loan balance if the individual fails to successfully complete the three year period. The rulings discuss the tax consequences under Internal Revenue Code Section 108 of the cancellation of debt income resulting from principal reduction, primarily the Qualified Principal Residence exclusion and the Insolvency exclusion. The Qualified Principal Residence exclusion, which allows the taxpayer to omit the taxable COD income, was extended through 2013 by recent legislation but it requires the taxpayer to reduce his basis in the home. The Insolvency exclusion likewise allows the borrower to escape taxation but requires the familiar reduction in tax attributes which apply under bankruptcy: reduction of net operating losses first, etc. This regime can result in a reduction in tax basis in the home, just as under the Qualified Principal Residence exclusion. If no exclusion under Section 108 is available, an individual can end up paying tax on the COD income. In fact, the rulings make it clear that if a portion of the property is rented in a commercial manner, the Qualified Principal Residence exclusion does not apply to that portion.

Tax Elections Under HAMP-PRA

As explained below, the rulings instruct mortgage servicers to issue Form 1099-C on Cancellation of Indebtedness to any individual in the first year of the program even though the individual may ultimately fail the program. According to the IRS rulings, a borrower may elect to recognize the entire reduction in the first year when the 1099-C is received or may elect to recognize the COD consequences each year as the program goes along. This invokes a little strategy on the individual's part to minimize his taxable income. Probably most participants receiving a 1099-C in 2013 will want to report the entire reduction in 2013 since the Qualified Principal Residence exclusion has been extended through 2013. However, if the Qualified Principal Residence exclusion is not extended in 2014, a borrower receiving a 1099-C in 2014, i.e. his first year in the program, may want to wait and report year by year in case he does not successfully complete the program.

Another dimension is the effect on basis of the choice to exclude the COD under the Qualified Principal Residence exclusion or the Insolvency exclusion, which is elective. As mentioned above, reduction of a debt under the Qualified Principal Residence exclusion requires an identical reduction in tax basis in the home, but not below zero. The Insolvency exclusion calls for reduction in favorable tax attributes in the following order: net operating losses, general business credits, minimum tax credits, tax basis of assets, then certain other attributes. In this case, there is a limitation on reduction of asset basis to the amount of indebtedness the asset secures, i.e. cannot create an asset which is "under water" debt-wise, at least at the time of discharge. The rulings provide latitude for amending returns in certain circumstances to change timing options and provide for restoration of tax attributes

where the borrower fails to complete and no actual principal reduction is made.

Careful Scrutiny of Mortgage Servicer Tax Reporting Will Be Needed

As mentioned above, the rulings instruct mortgage servicers to issue Form 1099-C on Cancellation of Indebtedness to any individual in the first year of the program even though the individual may ultimately fail the program. This sets up a situation in which IRS may receive a 1099-C showing the entire reduction in the first year though the taxpayer has elected to report one third of it per year. An appropriate footnote along with use of Form 982 Discharge of Indebtedness should be added to the individual's tax return in hopes of forestalling an IRS "document mismatch" notice. Also, the instructions make clear the 1099-C has to be issued even if the borrower qualifies for one of the Section 108 exclusions. Again, appropriate footnotes and use of Form 982 can help forestall IRS inquiries.

The IRS rulings also clarify the treatment of the HUD subsidy to the mortgage servicer to help pay for the reduction in the underlying mortgage principal. Generally the IRS treats that amount as a form of nontaxable welfare payment to the underlying borrower. However, if part of the residential property is rented out in a commercial manner, the HUD subsidy is reportable on Form 1099-MISC and is includible in the borrower's taxable income. A further problem stems from the fact that these programs and guidance are so new and the tax law was not amended until January 2, 2013. Accordingly, the IRS recognizes that some of the 1098 forms issued by mortgage servicers will include the government subsidies in the 1098 forms. In that case mortgage servicers are instructed to send out supplementary plain paper explanations of the amounts collected from the borrower. All this can create a confusing situation of duplicated amounts and questions about which are the correct figures to report for tax purposes, so taxpayers and their representatives will have to be diligent.

Commentary

The logic by which the IRS concludes that entering into the agreement constitutes a "permanent modification" of the underlying mortgage necessitating issuance of Form 1099-C at the front end is a bit of a stretch since they will probably have many cases where the full three year program is not completed successfully resulting in an overstatement of the reported cancellation of the individual's debt. But in the view of IRS it is probably necessary to inform their auditors when a taxpayer who is under audit is receiving this debt relief and should be reporting it in whole or in installments.

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

NEW LAW ALLOWS TAX LEVIES AGAINST FEDERAL EMPLOYEES THRIFT SAVINGS PLAN

President Obama recently signed into law P.L. 112-267 which clarifies that an Internal Revenue Service tax levy can be applied to a federal employee's accumulated amount in his federal Thrift Savings Plan, a plan similar to the 401(k) in the private sector.

CALIFORNIA: NOTICE OF TRUSTEE QUALIFICATIONS REQUIRED

The Franchise Tax Board of the State of California released the following notice on January 17, 2013:

Revenue and Taxation Code section 19089 provides, in part, that "[e]very trustee in a case under Title 11 of the United States Code, receiver, assignee for the benefit of creditors or like fiduciary shall give notice of qualification as such to the Franchise Tax Board in the manner and at the time that may be required by regulations of the Franchise Tax Board." In order to implement this notice requirement, the Franchise Tax Board (FTB) has recently adopted section 19089 in Title 18 of the California Code of Regulations, which identifies who is required to give notice of qualification, the manner in which notice must be provided, the time requirement for providing the notice, and whether any exemptions to the notice requirement are appropriate. Every trustee in a case under Title 11 of the United States Code, receiver, assignee for the benefit of creditors or like fiduciary appointed and/or assigned on or after March 18, 2013 ... shall give notice of qualification as such to the Franchise Tax Board at the address or fax number listed below.

Bankruptcy Section Manager MS A340 Franchise Tax Board PO Box 2952 Sacramento Ca 95812-2952

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SUMMARY OF RECENT TAX CASES

Trustee Could Compel IRS to Turn Over Estimated Payments Made by S Corp

The Internal Revenue Service was compelled to turn over estimated tax payments made on behalf of the individual shareholders by their S corporation as part of a fraudulent arrangement. Equipment Acquisition Resources (EAR) was an Illinois corporation that sold and serviced semiconductor-manufacturing equipment. EAR was a subchapter S corporation, meaning that the company itself was not subject to income taxation; instead, tax on the company's income or loss was passed through to the shareholders on a pro rata basis. Beginning in at least 2005, Sheldon Player, one of EAR's shareholders, used company assets to perpetrate a "massive fraud." The fraud was uncovered in 2009, and all of EAR's officers and directors resigned and were replaced by new officers and directors. Shortly thereafter, in October 2009, the company filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code. Between October 2007 and December 2008, EAR made nine payments on behalf of three shareholders, totaling \$4.7 million to cover the shareholders' individual passthrough federal tax liabilities. In January 2010, EAR, as debtorin-possession with the powers of a trustee under 26 U.S.C. §1107, filed a two-count adversary complaint against the United States seeking to recover these tax payments. In general, the complaint characterized the transfers from EAR to the IRS as "fraudulent transfers" recoverable under Bankruptcy Code sections §§544(b), 548, and 550. The IRS raised a number of defenses including sovereign immunity, the debtor was barred from bringing a fraudulent transfer action against the IRS under state (Illinois) law and various Internal Revenue Code sections on limitations of time periods for recovery. Both the Bankruptcy Court and the District Court held for the S corp (Trustee) and ruled that IRS was compelled to turn over the portion of the estimated tax payments at issue. [In re Equipment Acquisition Resources, Inc. Debtor. United States of America, Appellant v. Equipment Acquisition Resources, Inc., Appellee. U.S. District Court, N.D. Illinois. East. Div.; 11 C 05045, January 4, 2013.]

Bankruptcy Court: Chapter 13 Trustee Could Not Recover Post-Petition Tax Refund

This is more fallout from the 2011 decision by IRS to cease sending individual income tax refunds to Chapter 13 trustees because of the administrative nightmare it caused the IRS. In this case, the court handed the Trustee a pyrrhic victory ruling that a Ch. 13 debtor's post-petition federal income tax refund was property of the estate but the court could not compel debtors to turn it over because Section 542(a) of the Bankruptcy Code only applies to property the trustee may use, sell, or lease under section 363. Moreover, section 1306(b) provides that debtors shall remain in possession of all property of the estate unless a confirmed plan provided otherwise. Consequently, while the tax refunds were property of the estate, the trustees could not compel their turnover pursuant to section 542(a). The court stated that a Trustee may seek a plan modification after a debtor receives a tax refund under certain circumstances. [Terry and Denise Hymond, Debtors. ... U.S. Bankruptcy Court, N.D. Texas, Fort Worth Div., December 21, 2012]

North Carolina Court Also Rules Tax Debt Is Not Consumer Debt for Chapter 13

An individual debtor filing a petition in Ch. 7 generally has to pass a "means test" to seek an immediate discharge of his debts instead of being funneled into a five year debt payment program under Ch. 13. The purpose of the "means test" is to inquire whether an individual has too much income to be allowed an immediate discharge of his debts. However, if more than 50% of his debt is non-consumer debt, he may proceed toward a Ch.7 liquidation without undergoing the "means test." In a recent case a North Carolina bankruptcy court followed a number of precedents in ruling that federal income tax debt is "non-consumer" debt. Since the addition of the tax debt put the debtor over the 50% mark, he was allowed to proceed in Ch. 7 without any inquiry into whether his income was too high to receive a discharge of his dischargeable debts. [In re John Alfred Kintzele, Jr., Debtor., U.S. Bankruptcy Court, E.D. North Carolina, Raleigh Div.; January 18, 2013] ■

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IP Licensing continued from p. 5

Section 365(n) has some important limits. First, it expressly provides that the licensee may only retain its rights as they existed immediately before the bankruptcy proceeding commenced. In return, the licensee is obligated to continue to make any required royalty payments to the licensor due under the license for the remaining term of the agreement, but is deemed to have waived any set-off rights with respect to those payments. The non-debtor licensee also can retain rights under any ancillary aspects of the license including the right to source code or other technology related to utilization of the licensed IP. These provisions are designed to protect the licensee and its ability to continue to use the licensed IP. If the license is rejected, however, the debtor-licensor will no longer have to perform any of its obligations under the now-rejected license.

The prospective purchaser of the IP encumbered by a rejected (and then elected over) license is faced with taking ownership of the IP asset subject to the license. If that license is "exclusive," the buyer may not be entitled to practice the patent or otherwise use the IP to its own benefit—it may be relegated to receiving the royalty stream from the license itself. If the license is non-exclusive, the purchaser can enjoy the full benefit of the acquired IP and receive the required royalty payments from the licensee's use of the IP as required by the license.

The key to determining the scope of protections provided by Section 365(n) relates to the Bankruptcy Code's definition of "intellectual property," which specifically includes patents, copyrights, and trade secrets.¹² It does not mention trademarks. Therefore, according to Congress' charge, a licensee to a patent, copyright, and/or trade secret can elect over any rejection of the license by the DIP or Trustee to continue using the IP, subject to the provision of Section 365(n). Until recently, most courts viewing the omission of "trademarks" from the list of defined "intellectual property" followed the reasoning of Lubrizol Enterprises v. Richmond Metal Finishers, Inc., 13 in which the Fourth Circuit held that, when a trademark license is rejected in bankruptcy, the licensee loses the ability to use any licensed trademarks on a go-forward basis. 14 Because Congress had excluded "trademarks" from the definition of intellectual property under the Bankruptcy Code, trademark licensees were not afforded the protections of Section 365(n).

On July 9, 2012, the Seventh Circuit, in *Sunbeam Products, Inc.* v. Chicago American Manufacturing, LLC, 15 became the first federal circuit court to contradict Lubrizol, holding that the trustee's

rejection of a trademark license did not abrogate the licensee's contractual rights in the trademarks. To support this holding, the Seventh Circuit found that the limited definition of intellectual property in Section 101(35A) means only "that §365(n) does not affect trademarks one way or another." The Sunbeam decision has the potential to inject uncertainty into the Bankruptcy Code's overall treatment of trademark licenses and undoubtedly invites the U.S. Supreme Court to take up the question for review. For now, at least, Sunbeam injects uncertainty into the issue of how trademark licenses are affected, if at all, by a debtor-licensor's rejection.

Assumption or Assumption and Assignment—Can a Licensee-Debtor Continue or Sell its Licensed Rights?

As noted above, Section 365(a) provides that a debtor, subject to the court's approval, "may assume or reject any executory contract."¹⁷ This provision gives a debtor the authority to continue or eliminate contracts for the benefit of the bankruptcy estate. The Bankruptcy Code also allows a debtor to assign a contract to a third-party despite the existence of a non-assignment provision in the contract and objections from the debtor's contracting partner. This is truly a harrowing thought when considering the potential implications for licensed IP. Take, for example, a scenario in which your licensee falls into bankruptcy and is nonetheless able to transfer to your biggest competitor the license rights to your patent—a patent which is the key to effectively competing in your industry—despite your objections and efforts to stop the sale. With regard to IP licenses, however, distinct limitations on the debtor's ability to assign an IP license absent the licensor's consent may apply.

As a general rule, courts recognize the limitation on the debtor's authority to assume and assign a non-exclusive IP license absent consent when the license expressly prohibits assignment or provides no expressed authorization for assignment. When the license is exclusive in nature, the parties are confronted by more unknowns.

Assumption of a contract under Section 365 requires the debtor to: (1) cure any existing defaults or provide assurances that the defaults will be cured promptly; (2) provide compensation or adequate assurances to the non-debtor party for monetary loss resulting from any existing default; and (3) provide adequate assurances to the non-debtor party that the contract will be performed on a prospective basis.¹⁸ The concept of "adequate assurance" is flexible but normally requires showing that the debtor (or its third-party assignee) has the ability to perform the contract's obligations after assumption.

^{12 11} U.S.C. § 101(35A).

¹³ *Lubrizol*, 756 F.2d at 1048. The Lubrizol decision was actually directed to all types of intellectual property—patents, copyrights, and trademarks. Congress overturned certain aspects of *Lubrizol* when it added Section 365(n) to the Bankruptcy Code in 1988.

¹⁴ See, e.g., In re Old Carco LLC, 406 B.R. 180, 211 (Bankr. S.D.N.Y. 2009); In re HQ Global Holdings Inc., 290 B.R. 507, 513 (Bankr. D. Del 2003); In re Centura Software Corp., 281 B.R. 660, 674 (Bankr. N.D. Cal. 2002).

¹⁵ Sunbeam Prods., Inc. v. Chicago Am. Mfg., LLC, --- F.3d. ----, 2012 WL 2687939, *4 (7th Circuit, July 9, 2012),

¹⁶ It is questionable whether courts will follow the *Sunbeam* decision in light of its strained logic in analyzing the various aspects of Section 365 and ignoring the Congressionally-created definition of "intellectual property."

^{17 11} U.S.C. § 365(a).

^{18 11} U.S.C. § 365(b)(1).

Is the IP License Exclusive or Non-Exclusive?

As noted above, IP licenses generally are considered executory in nature. The question of exclusivity may, however, depend on whether the rights granted under the license are exclusive or non-exclusive. Courts are more likely to view an exclusive license as non-executory in that it usually represents a transfer of a greater portion of the subject IP.¹⁹ If a debtor can demonstrate some form of remaining obligation under the contract, the court normally will find that its license is covered by Section 365.

An exclusive license generally confers significant rights to control the subject IP and usually is transferable by the licensee even though the license agreement may restrict assignment. A nonexclusive license generally grants a more limited personal interest and typically cannot be assigned without the licensor's consent.

However, the type of IP at issue in the license is critical in determining whether the license may be assumed or assumed and assigned to a third-party. For example, trademark licenses typically are considered personal in nature. Trademark law generally is directed to protecting the goodwill associated with a particular trademark. The owner of the trademark usually retains the right to prevent assignment unless the license agreement expressly provides otherwise. *In re MCP Marketing Group, Inc.*²⁰ is illustrative. There, a debtor-licensee sought to assume and assign a non-exclusive trademark license. The court determined that trademark licenses are personal in nature and non-assignable absent consent from the licensor.²¹

Patent Licenses—Generally Not Assignable Absent Consent

Courts have consistently held that non-exclusive patent licenses may not be assigned pursuant to Section 365 absent consent by the licensor.²² Even in instances in which the patent license is "exclusive," courts have found that the licensor's consent is required prior to assignment of the license to an unrelated third-party.²³ Thus, the issue of assignability of an exclusive patent license may be dependent on its inclusion of a non-assignment provision.

Copyright Licenses—Exclusive Licenses Likely Are Assignable Absent Consent

In general, whether Section 365(c) allows assignment of a copyright license is dictated by the issue of exclusivity. Case law generally provides that a non-exclusive copyright license provides a personal interest that cannot be assigned absent authorization from the licensor.²⁴ As such, assignment generally is not allowed for non-exclusive licenses absent consent or expressed provisions

- 19 See In re DAK Industries, Inc., 66 F.3d 1091, 1096 (9th Cir. 1995).
- 20 In re MCP Marketing Group, Inc., 337 B.R. 230, 233 (D. Nev. 2005).
- 21 Id.
- 22 See In re Catapult Entertainment, 165 F.3d 747, 750-755 (9th Cir.) cert. denied 120 S.Ct. 369 (1999).
- 23 See In re Hernandez, 285 B.R. 435, 439-440 (Bankr. D. Ariz. 2002) (License agreement with expressed non-assignment provision).
- 24 See In re Patient Education Media, Inc. 210 B.R. 237, 242-243 (S.D.N.Y. 1997).

in the contract. However, an exclusive copyright license usually is assignable even if the license itself expressly prohibits assignment.²⁵

Trademark Licenses—Usually Not Assignable Absent Consent

As noted above, trademark licenses usually are considered personal in nature and are thus not likely assignable without the licensor's consent, regardless of whether the license is exclusive or non-exclusive. In addition, the Seventh Circuit Court of Appeals recently addressed assignability of trademark licenses by a licensee in a bankruptcy proceeding, holding that a license may not be assignable unless there is an express provision in the license permitting assignment by the licensee. ²⁶

XMH Corporation and its subsidiary Simply Blue filed for bankruptcy under Chapter 11 of the Bankruptcy Code. XMH requested permission of the bankruptcy court to sell the assets of Simply Blue, which included a contract between Simply Blue and Western Glove Works. The subject contract obligated Western Glove Works to provide Simply Blue with a license to use a trademark for a period of time, and once that period elapsed, Simply Blue would provide Western Glove Works with certain services for products bearing the subject trademark. Western Glove objected to the assignment arguing that the contract was a trademark license, and that absent its permission, Simply Blue could not assign the contract to a third party.

Citing Section 365(c)(1), the Seventh Circuit found "applicable law" authorizing Western Glove to refuse to accept performance from a third-party purchaser, whether or not the contract itself specifically prohibited assignment. Under the Act, the court found "applicable law" to mean U.S. trademark law. Reviewing a number of trademark cases, the court found a "default rule" that a trademark licensee cannot assign its rights and obligations under a license unless the license agreement expressly permits assignment. The court focused on the default rule found from its review of a number of trademark cases that a licensee of a trademark license cannot assign a license unless the license agreement expressly permits assignment.

In sum, the court reasoned that basic trademark law prohibited the requested assignment. If an unauthorized third party is granted the right to use the trademark due to the assignment of the license without the owner's permission, the owner will no longer be able to control the product or the use of the trademark. Because the contract between Simply Blue and Western Glove Works did not contain a provision expressly allowing assignment by the licensee, the court barred the assignment absent the expressed consent of Western Glove Works. This case emphasizes the importance of carefully drafting trademark licenses to guard against unintended consequences if the licensee ever falls into bankruptcy.

IP Licensing continues on p. 30

²⁵ See Gardner v. Nike, Inc., 279 F.3d 774 (9th Cir. 2002).

²⁶ In re XMH Corp., 647 F.3d 690 (7th Cir. 2011).

Does the Debtor Actually Own the IP It Is Trying to Sell?

Additional due diligence regarding IP involved in a bankruptcy proceeding should include a determination of the basic question: Who actually owns and has rights to the IP? Third parties alleging ownership interests in the debtor's IP can certainly derail efforts by the debtor to sell those assets.

For example, in the aforementioned Kodak bankruptcy, an ownership dispute exists as to at least 10 of the patents Kodak claims as part of the IP in its estate. Shortly after Kodak instituted its Chapter 11 bankruptcy, Apple and its spin-off FlashPoint voluntarily joined the matter to assert rights in 10 patents directed to digital camera technology. In their filings, Apple and FlashPoint contend that they have an ownership interest in certain of the patents Kodak is attempting to sell in its bankruptcy proceedings. In response, Kodak filed a Motion in Aide of the company's planned sale of the IP assets, which the bankruptcy court denied, holding that Kodak was wrong in trying to litigate the issue of a contested ownership matter in its Chapter 11 case. The court agreed with Apple and FlashPoint that the issue should be decided in an adversary proceeding, allowing for discovery.

Kodak's adversary proceeding, directed to stamping out Apple's ownership claims, is necessary to protect Kodak and its affiliated debtors from attempts by Apple and FlashPoint to delay Kodak's efforts to sell its patent portfolio. In sum, Kodak seeks a declaration that Apple and FlashPoint have no ownership interest in any of the 10 patents and that Kodak is permitted to sell those patents free and clear. According to Kodak, Apple's claim arose from joint development work between Kodak and Apple in the 1990s and Apple's subsequent assignment of those rights to FlashPoint. Monetizing the portfolio, which Kodak claimed has generated approximately \$3 billion in licensing revenues, is contemplated as part of the company's DIP financing and is key to Kodak's emergence from Chapter 11.

A Success Story

There is little doubt that bankruptcy proceedings can provide excellent opportunities for buying distressed IP. In 2008, Circuit City Stores, Inc., the pioneer of the electronic superstore format, filed a Chapter 11 bankruptcy, which was later converted to a Chapter 7 liquidation. Following Circuit City's liquidation, Systemax, Inc. acquired the company's IP at auction for \$14 million, including Circuit City's trademark, brand name, and Internet domains. Systemax reported a \$67 million sales increase that year, which it largely attributes to the acquisition. Despite the risks, the rewards that IP can yield are extraordinary. And with the high rate of corporate bankruptcy filings, the market is rife with

opportunity. But understanding the interworkings of bankruptcy and intellectual property laws is imperative to realizing the full value of the IP assets and avoiding any unintended consequences from existing encumbrances attendant to the IP.

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This article originally appeared in the September 2012 issue of The Licensing Journal.



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