AIRA | Association of Insolvency & Restructuring Advisors™

Journal

News from the Association of Insolvency & Restructuring Advisors

Volume 25, Number 2

Risk Free Rate Update

Roger J. Grabowski
Managing Director,
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Previously I have written on the relationship of the risk-free rate and the equity risk premium during and since the Great Recession of 2008-2011 began. As we enter the last half of 2011, I thought an update may be useful.[1]

A risk-free rate is the return available on a security that the market generally regards as free of the risk of default. The risk-free rate reflects three components: (1) Rental rate (real return for lending the funds over the investment period, thus forgoing consumption for which the funds otherwise could be used), (2) Inflation expectations, and (3) Maturity risk or investment rate risk (risk that the market value of the investment's principal will rise or fall during the period through maturity, as a function of changes in the general level of interest rates).

The Great Recession of 2008-2011 has proven to be anything but a period of stability. The "standard" practice of many practitioners has been to simply add the "spot" yield on 20-year U.S. government bonds (the risk free rate) to the arithmetic average of realized risk premiums as reported annually by Morningstar in the SBBI Yearbook as their base cost of capital estimate. But this methodology has created numerous erroneous estimates of a base cost of equity capital all through the Great Recession of 2008-2011.[2]

For example, as of December 2007, the yield on 20-year U.S. government bonds was 4.5% and the arithmetic average of realized risk premiums as reported in the SBBI Yearbook for 1926-2007 was 7.1%. But as of December 2008, the yield on 20-year U.S. government bonds was 3.0% and the SBBI realized risk premiums for 1926-2008 was 6.5%. So just at the time that the risk in the economy increased to maybe its highest point, the base cost of equity capital using realized risk premiums decreased from 11.6% (4.5% plus 7.1%) to 9.5% (3.0% plus 6.5%).[3]

The world economies were (and remain) in crisis. Financial crises are often accompanied by a "flight to quality". Investors are looking for places to "park" funds that they consider free from loss of principal. During those periods they are not looking for yield. As nominal returns on "risk-free" securities fall dramatically for reasons other than inflation expectations they may, without adjustment, become less reliable as the best building block upon which to estimate the cost of equity capital.

During these episodes of flight to quality, one may need to reevaluate simply using the quoted risk-free rate as the basic building block in estimating the cost of equity capital. In these instances, one needs to identify whether market (spot) interest rates have been artificially influenced by a flight to quality. On a monthly basis, we monitor changes in market interest rates relative to a rolling average of prior months' interest rates and various economic indicators, such as the flow of funds, the implied volatility derived from options, changes in estimates of inflation, etc. Once we suspect that the market interest rates are abnormally low, we use a build-up approach to estimate a normalized risk-free rate by looking at the real rate of interest earned historically, and long-term inflation estimates.

Closing Thoughts

At the time I write this (the morning of August 8, 2011), it appears that the initial reaction in worldwide equity markets has been to sell-off. In the U.S. for example, the Dow and S&P 500 indices appear to have dropped significantly in AM trading. The following days and months promise to be quite volatile.

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1 Roger J. Grabowski, "Developing the Cost of Equity Capital: Risk-free Rate and ERP during Periods of "Flight to Quality," Business Valuation Review (Winter 2010): 172-185.

2 The recession technically began in December 2007 and technically lasted 18 months to June 2009, the longest since the 1929 crisis. But in many persons' opinion the recession continued, hence this author is using the term the "Great Recession" of 2008-2011. Many analysts admit that with the poor growth in GDP during the first half of 2011 we may be on the verge of reentering recession (i.e., a "double dip").

3 This author recognizes three periods in recent years during which the quoted risk-free rate is too low relative to its three underlying components (rental rate, inflation expectations, and maturity or horizon risk): November 2008–March 2009, June 2010–November 2010, and May 2011–present (note that "present" as of the time of writing is August 8, 2011).

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Letter from the President

Stephen Darr, CIRA, CDBV
Mesirow Financial Consulting LLC

This issue marks the half-way point in my term as president of AIRA. During this time, I have continually been impressed with the outstanding quality of the membership and the AIRA staff. I am sure that the key to attracting and keeping members and staff in our organization is the excellence of our conferences and educational materials.

The Annual Conference in Boston this year was fully in keeping with AIRA's high standards. For those of you who could not attend, I am sorry that you missed a great opportunity to network with your peers, learn a lot and enjoy the City of Boston—even the weather cooperated by providing four days of very pleasant temperatures, sunshine and humidity. Conference Co-chairs Paul Moore, Eric Danner and Sheila Smith, together with the members of the Conference Planning Committee, did a great job and I thank them for their efforts.

Upcoming AIRA events and conferences that merit your interest include:

- AIRA's sponsorship of the Opening Reception and breakfast panel at the NCBJ Annual Conference in Tampa from October 12-15, 2011
- 10th Annual Advanced Restructuring and Plan of Reorganization Conference, to be held in New York City on November 14, 2011
- Expert Witness Training Program (Phase 1), which is an exciting, brand-new program to be held in Atlanta from November 15-17, 2011
- VALCON 2012, which will be held in Las Vegas from February 22-25, 2012
- 28th Annual Bankruptcy & Restructuring Conference, which will be held in San Francisco from June 6-9, 2012

In addition, I know that you are familiar with the AIRA Journal since you are reading this letter. Please consider writing an article about something that really interests you—chances are it will really interest many others as well. Please contact Grant Newton, Angela Shortall, or me if you can contribute an article soon.

Similarly, another area where member contributions are welcomed is AIRA's webinars which are scheduled approximately every month on timely, emerging issues. The sessions run for 100 minutes and there are a few open slots available, so please contact Grant or me if you would like to coordinate a session on a topic that you find compelling.

I look forward to working with you for the remainder of my term,

Stephen B. Darr

Risk Free Rate Update *continues from p. 1*

While equities initial reaction was a sell-off, the yields on U.S. government 10-year bonds have actually decreased in Monday AM trading following Friday's S&P's downgrade. Investors seem to be selling equities and buying U.S. government debt. Many may wonder why interest rates on U.S. government debt have not skyrocketed as a result of the downgrade by Standard & Poor's, or during the debate by Congress to increase the debt ceiling and accompanying spending cuts.[4]

First, it is important to remember that the U.S. government has (in effect) defaulted at least three times on its obligations during the 20th century. In 1934, for example, the U.S. government banned ownership of gold and eliminated the right to exchange gold certificates for gold coins. The government immediately revalued gold from $20.67 to $35 per troy ounce, devaluing dollar holdings by 40%. A second example is Congress' unilateral ban on the redemption of "silver certificates" for silver or silver bars in 1968, a practice that had been in place since 1934. And in 1971, foreign governments' ability to exchange dollars for U.S. government gold until 1971 was stopped.[5] Each time the U.S. economy recovered from the jolt.

Second, the sovereign debt crisis in Europe continues despite another agreement to bail out Greece. That agreement fails to address the other sovereign debt problems in Euro-zone. The current Greek agreement calls for an effective 20% hair-cut on outstanding Greek sovereign debt. Italy and Spain are now being dragged into the crisis, but they have their own share of debt problems which will prevent them from contributing to the Greek bail-out. Germany (the perceived safe haven in the Euro-zone) would not have the capacity to bail-out countries such as Italy or Spain (should the need arise), given the size of these economies.

In periods of high uncertainty, investors need as safe a haven as possible given the likelihood of real defaults, and U.S. government debt may still be perceived as the best of the worst. For example, Warren Buffet, as quoted by CNBC on August 8, 2011, said (he) is still buying U.S. government short term debt (T-bills), even though yields have fallen so low. "If I have to buy (T-bills) at a zero percent yield, I will," he says. "I don't like it, but we'll do it." Even though funds looking for safety could be parked in other currencies (e.g., Swiss franc), these other currencies simply do not have the volume of outstanding currency nor liquidity to absorb the amounts of money looking for safe havens.

Third, this crisis differs from September 2008. The market has had time to prepare and has accumulated liquidity to weather a storm. While the potential of a technical default by the U.S. government on August 4 may have appeared to trigger investors concerns, the economic slowdown in the U.S., Europe and even in developing economies has been an ever increasing concern. Individual investors and companies have been selling risky assets and moving them into safer assets including cash holdings in banks. As bank deposits have grown, banks have applied more funds in the investment of choice for the short-term --U.S. government securities. This has further driven down the yields on the shorter end of the U.S. government yield curve.

Lastly, the recent sovereign debt downgrade by S&P resulted from the debt overhang of the U.S. government, which is estimated to be at least $60 trillion (when one counts the present value of all obligations direct and guaranteed of the U.S. government).[6] Such a downgrade was likely priced into the market already but the current flight to quality is overwhelming any rate increase. In the end, it appears that the agreement by Congress and the President to avoid so-called "default" in the near term was not enough to assuage the market's fears of impending fiscal hazards, and may have been interpreted (by some, at least) as an indication of a general lack of resolve by the parties involved to reach any meaningful agreement. While the markets did not like the drama leading up to August 4, 2011 (the deadline to raise the debt ceiling), market participants expected some sort of compromise agreement to keep the U.S. from defaulting.

Where do we go from here? Maybe we need to heed Warren Buffett's advice:

"I could end the deficit in 5 minutes. You just pass a law that says that anytime there is a deficit of more than 3% of GDP all sitting members of Congress are ineligible for re-election." Warren Buffett (July 8, 2011)

The author thanks Carla Nunes and Jim Harrington of Duff & Phelps LLC for their helpful comments. The author accepts full responsibility for any errors. These comments reflect the position of the author and are not the official position of Duff & Phelps LLC.

4 The U.S. Department of Treasury has no authority to issue or incur debt beyond the debt ceiling set by Congress. The 2011 debt ceiling debate was centered on the statutory limit of the amount of indebtedness the government of the United States can have and whether this limit should be raised. If the debt ceiling were not raised, either government spending would have to be decreased, or debt would have to be paid later than promised, leading to a technical default.

5 Source: Ron Paul on Bloomberg (July 22, 1011)

6 Bill Gross, Investment Outlook, April 2011.

Executive Director's Column

Grant Newton, CIRA
AIRA Executive Director

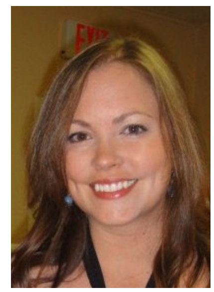
AIRA is pleased to welcome two new full-time professionals to serve members and carry out the functions necessary to accomplish our mission.

Lorren Biffin, Director of Information Technology

Lorren's responsibilities include general IT support and database server administration, as well as the new direction of AIRA's web presence. He has a strong passion for new and emerging web technology and is working with the whole of the AIRA staff to introduce lean, powerful standards for both internal and public-facing operations. His most recent previous employment was as Senior Developer with Sony Online Entertainment's Bellevue, WA, location. At Sony, Lorren worked with developers, server-administrators, artists and producers from various studios around the country to quickly deliver marketing platforms in a high-turnaround environment.

Lorren lives in Medford, Oregon, with his wife Nichelle and their three daughters, Sarianna, Aria, and Autumn.

Lauren Cypher, Conferences and Marketing Coordinator



Lauren's responsibilities include coordinating conferences, membership development, promoting AIRA at industry events, and administrating CPE and CLE credit. Lauren comes to AIRA from the American Cancer Society Great Lakes Division where she worked as Community Program Coordinator. Lauren worked with health care systems and health departments in Michigan to provide access to services and programs for individuals in treatment; she also trained and supervised over 150 volunteers in 9 programs. She also worked with the NCAA as a fundraiser for Coaches vs. Cancer, was the committee chair for National Cancer Survivor's Day, and coordinated the Making Strides Against Breast Cancer 5k Run/Walk. Lauren is already using her extensive experience to positively impact AIRA conferences and programs.

Lauren and her husband Erinn live in Medford.

I would again like to offer special thanks to the co-chairs (Eric Danner, Paul Moore, and Sheila Smith) and planning committee of the 27 Annual Conference for their efforts to bring about an excellent program in Boston. As Jack describes so well in his column on p.5, the conference creates an invaluable opportunity for experiences and relationships among an exceptional gathering of professionals. For those of you that attended this year, thank you for helping to make it a success; for those who were not in attendance, I hope you will be able to join us next year in San Francisco.

Best regards,
Grant

Ken Malek presented AIRA's 2011 Manny Katten Award to Jack Almquist

2011 Emanuel M. Katten Award Presented to John "Jack" Almquist

AIRA's Board of Directors selected John "Jack" Almquist to receive the 2011 Manny Katten Award for outstanding service to AIRA and the bankruptcy and restructuring profession. Jack Almquist was honored during the Annual Banquet on Thursday, June 9, at the Annual Conference in Boston. Ken Malek, past president of AIRA, presented the Manny Katten Award. A member of AIRA since its inception, Jack has always been a strong proponent of AIRA, as illustrated by the fact that he has attended all of AIRA's conferences except one. His distinguished career has involved tax planning, consulting, and tax audits; mergers and acquisitions; consulting with businesses related to general business, insolvency, restructuring; and financial statement reporting. His experience expands a large number of industries including construction, real estate, retail, manufacturing and distribution. A graduate of the University of Minnesota and Minnesota School of Business, Jack's passions include his work with the Hobey Baker Memorial Award Foundation, hockey, his grandchildren, and spending time at the family cabin on the Lake of the Woods. ■

AIRA Scholar in Residence

Professor Jack F. Williams, CIRA, CDBV
Georgia State University College of Law
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LEARNING AND TEACHING

As we wrapped up another Annual Meeting in Boston, I had the opportunity to visit with some new members of the AIRA. As Yogi Berra was fond of saying, it is fascinating what you hear when you just listen. It seemed that Boston brought out more than its fair share of newbies, first timers to an AIRA annual meeting. I think I have socks older than some of these folks. Yet, I was impressed with their sophistication, command of knowledge, and energy. In the Financial Toolbox session, the newbies participated and offered up some very interesting perspectives and points. Outstanding presenters walked the group through the beginning, end, and middle of a bankruptcy case, exploring the many financial milestones from a reporting, substantive, and procedural perspective. We covered the relationship between reorganizational value of the assets, enterprise value, and non-interest bearing debt. We talked about rolling forward values for certain assets based on market indicators, a reliable estimator of value in certain industries when you want to estimate fair value from a historical value (book or otherwise) for purposes like filling out the schedules, etc. We also talked about timing for entrance into and exit from bankruptcy. Excellent judges, lawyers, financial advisors, and academics added to a wonderful program.

But back to the new folks. There was something simply delightful about their enthusiasm and quest to learn. Equally impressive was the time and advice that the "old timers" gave to the new folks, gently guiding them through the thicket of our professions with a grace borne from experience, missteps, mistakes, and successes. It was touching and, for me, nostalgic.

This may shock some of you, but I was a newbie once. I even remember my first AIRA annual meeting. I was a young academic with a full-head of hair (ok, I am exaggerating about the hair, but this is my column) lost in a sea of people, almost all of whom I did not know. Professor Newton had invited me to speak after we met at the annual meeting of another bankruptcy organization to which many of us belong. I was slightly intimidated by the crowd. I was speaking on a bankruptcy tax subject and wanted to make sure that I got my talk right. I knew that many people paid hard-earned money and took time from their busy schedules to attend, and I did not want to let them down. I have approached each of my talks this same way; speaking before you is an honor that I take to heart, like many of our presenters, and do my best not to let you down in my preparation and delivery.

I think I did ok, but I can hardly remember the talk itself. What I have never forgotten is what happened after that talk. Jack, Jack, and Don came up to me and made me feel like family. They gently suggested that I think about some of my topics from a different perspective in ways that would resonate with practitioners who see these issues in a slightly different context. Dave joined in and encouragingly suggested that I consider how the tax issues fit in the overall financial advisory basket, reminding me that financial advisors often have to "sing, dance, and act." Traci asked whether I had considered the valuation challenges associated with the tax issues I had unpacked. No, I had missed that aspect. She knew it but did not belabor the point; rather, she used the impromptu class to teach me a few valuable lessons on the importance of seeing the whole financial picture. Later, a bankruptcy judge (I am withholding the name so that I do not embarrass him), new to the bench, joined in, talking about some of the financial and valuation issues that seem to regularly percolate in bankruptcy cases, and engaging in what we all had to say. No rank was pulled here.

What began as a talk on the subject of bankruptcy taxation ended in the greatest teaching lesson I have ever received. The Judge was (and is) the finest of gentlemen – thoughtful, distinguished, respectful, and very interested in what practitioners of all stripes have to say about these issues. For years I thought that if I were able to become a judge someday, he would be the type of judge that I would want to be. Several years ago, I came to the realization that he is also the type of man I aspire to be. Respectful, honorable, friendly, and dignified – aware of his special role as judge – but humble. Jack, Jack, Don, Dave, and Traci taught me patience, respect, humility, and, by example, the most important lesson of all; the honor of passing on knowledge from veteran to rookie. And they shouldered this task with enthusiasm and a commitment to leave our profession better than they found it.

Yes, on that day, five financial advisors and a bankruptcy judge taught me how to teach, and, in the process, how to become a better person. They taught me that although complementary, knowledge and experience are two different things. Combined in the correct measure, they give birth to wisdom. For that, I am forever grateful.

In the end, no institution is any greater than the people who toil within it. The AIRA has always attracted the top of our respective fields. Our members take seriously the role of educator, passing down knowledge and tales from experience. Our present impressive group of new folks sense this, absorbing as much information as they can from veterans all to willing to share.

I saw this cycle of wisdom in all its glory in Boston. It is a beautiful sight to behold. At one time, I was on the largely receiving end of that cycle. Presently, I have shifted more in the direction of the giving end. Of course, we all have something to teach and to learn. With that let me say – because I cannot say it enough – it is a great honor to serve as your Resident Scholar. I hope to continue to learn and to teach. That is, after all, what the AIRA is all about. ■

27th Annual Conference Highlights:

Zolfo Cooper/Randy Waits Awards

Brent "Lee" Fletcher, CIRA—Gold Medal
Managing Director, Marotta Gund Budd & Dezera

Ivan Todorov—Silver Medal
Manager, Grant Thorton LLP

Melissa Craft—Bronze Medal
Analyst, Alvarez & Marsal

Matthew English, CIRA—Bronze Medal
Director Bailey, Elizondo & Brinkman

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

GOLD MEDAL: Brent "Lee" Fletcher, CIRA—Managing Director with Marotta Gund Budd & Dezera, LLC in New York, NY. Prior to MGBD, he was the CFO of Lloyd Associates in Ashland, VA. Lee also received his CIRA certificate at the Annual Banquet. He holds a BA in Business from George Mason University.

SILVER MEDAL: Ivan Todorov—Manager with Grant Thornton LLP in San Francisco. Prior to Grant Thornton, Ivan was a Sr. Financial Analyst with Yahoo Inc., and is also the founder of TGA Management. Ivan received his MBA in Strategy, Finance and Marketing from Carnegie Mellon University.

TIED FOR BRONZE:

Melissa Craft—Analyst with Alvarez & Marsal in Atlanta, GA. Prior to Alvarez & Marsal, Melissa was an Investment Banking Analyst with Keefe, Bruyette & Woods. She received a BS in Business from Wake Forest University; MBA from the University of Virginia.

Matthew English, CIRA—Director with Bailey, Elizondo & Brinkman working with distressed companies in Northern California. Prior positions include Managing Director of Arch + Beam Global, and Manager with Deloitte, both in SF Bay Area. BS in Operations Research and Industrial Engineering, Cornell University.

Certificates of Distinguished Performance

Some candidates achieve composite scores on the CIRA exam that are only a point/a few points lower than the top three. Therefore, the Distinguished Performance Awards were created to recognize outstanding achievement of scorers that barely missed receiving medals. Distinguished Awards recipients that were present at the Annual Conference were (clockwise from upper left): Devi Rajani Villegas, CIRA – FTI Consulting, Toronto, Ontario; Ricardo A. Nieto, CIRA – Huron Consulting Group, Dallas, Texas; James Mallak, CIRA – Alvarez & Marsal (on right), Southfield, Michigan.

Not present at conference: Simon Joyeux – Ernst & Young LLP, New York, NY; William Markley – Alvarez & Marsal North America, Southfield, Michigan; Michael C. West, CIRA – Office of United States Trustee, Wilmington, DE.

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

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Bankruptcy Taxes

Forrest Lewis
Plante & Moran PLLC

A USEFUL TAX TOOL IN ACQUISITIONS: ELECTION TO TREAT STOCK PURCHASE AS ASSET PURCHASE 338(H)(10)

This article presents a brief overview of a popular technique for achieving the tax benefits of an asset purchase even though the acquisition is in legal form a stock purchase. As we all know, the general rule of tax planning for corporate acquisitions is "sellers want to sell stock and buyers want to buy assets." Sellers want to sell stock because they can deduct in computing the gain their basis in the stock which is often higher than their basis in the underlying assets. Also, selling stock entails a single level of tax and can yield capital gain which can be an advantage, even to a corporate seller because of possible capital loss carryforwards. Buyers want to buy assets because they can "step up the basis in the assets" for future depreciation and amortization, also business lawyers are always concerned about potential legal "skeletons in the closet" of the target corporation and thus advise against buying the stock of an existing corporation. The Internal Revenue Service takes a strong position that purchasing the stock of a target corporation does not normally increase the basis of the assets within the corporation. Electing the deemed asset sale technique gives the buyer a better tax result as it allows an increase in internal asset basis even though corporate stock was purchased. Although, the legal risk of the skeletons in the closet of the target is still there.

[This article deals only with the deemed asset acquisition election under Internal Revenue Code Section 338(h)(10). There is an alternate route under 338(g) which is seldom beneficial and will not be discussed in this article.]

There are two primary points to remember about the 338(h)(10) deemed asset acquisition election:

1) It is very useful in any situation where you want to avoid having to actually liquidate the corporation such as when the target corporation holds valuable assets or is subject to legal agreements which you don't want to disturb, more on this later.

2) The deemed sale technique is only of benefit to the buyer, so if you are representing the seller, you want to make sure the seller is duly compensated by an increase in selling price for agreeing to the inconvenience of the election.

Overview

In order to make the election, there must be a "Qualified Stock Purchase" of 80% of the target stock from unrelated parties within 12 months by a corporate purchaser. The seller and buyer have to be corporations but can either be a C (regular) corporation or an S (pass-through) corporation. The tax year of the target corporation closes on the day of the sale and the target corporation is treated as if it sold its assets just before the closing, so that the seller effectively pays the tax. The target corporation is generally treated as a newly formed corporation with asset basis increased to fair market value. An election on Form 8023 is filed with the Internal Revenue Service. Again, the assets are not legally transferred and the target corporation remains intact. More on all these points below.

Situations favoring the deemed asset acquisition

- Whenever the target holds any asset which is cumbersome to transfer such as realty, many different individual assets, intellectual property such as patents or licenses, etc.
- Whenever the target is subject to legal arrangements which are difficult to assign or rearrange such as liens, loan covenants, leases, other contracts or has beneficial agreements such as tax credits, property tax abatements, etc.
- Whenever the target is a regulated entity for which regulatory approval will be needed for transferring assets (though many times even the sale of a regulated entity's stock will require some level of regulatory approval)
- Facilitating an initial public offering of an existing company which is asset intensive where stepping up asset tax basis to fair market value would be highly beneficial

Qualified Stock Purchase

To qualify, a C corporation must purchase in a taxable transaction(s) at least 80 percent of a target corporation's stock within a 12-month period. Open market purchases of stock do qualify. However, acquisition of stock in taxfree transactions such as a Type B stock-for-stock reorganization would not qualify as it was not a taxable transaction.

Treatment of sale by a C corporation seller

Though there is a sale of stock and a deemed asset sale, the stock sale is ignored and the tax is paid only on the asset sale gain. Gain or loss from the deemed asset sale for a consolidated target is included in the consolidated return filed by the selling consolidated group for the tax year that includes the acquisition date. Gain or loss from the deemed asset sale for an unconsolidated subsidiary is reported on a final return for the taxable year that ends on the acquisition date. The transaction is treated for tax purposes generally as if the target transferred all assets to an unrelated person (i.e., new target) in exchange for the amount paid for the stock plus the amount of the target's liabilities in a single transaction at the close of the acquisition date. Thus, the selling group or unconsolidated subsidiary pays the tax on the gain. As mentioned earlier, if the seller had simply treated it as a stock sale, the gain would be capital. Since the deemed asset sale election was made, some of the gain will probably be treated as ordinary income due to depreciation recapture which may increase the tax paid by the seller. [For acquisitions of a consolidated group or subgroup, the election is also available so that asset basis of the subsidiaries may be stepped up if desired].

Treatment of sale of an S corporation seller

Though there is a sale of stock and a deemed asset sale, the stock sale is ignored and the tax is paid on the asset sale gain which is "passed through" to the shareholders. But there can be a certain amount of double taxation as S corporations are also subject to an entity level "built in gains tax" in certain situation. The tax year of the S corporation ends at the time of sale, S corporation

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status is terminated and the final return passes through to the shareholders both the results of the taxable year and the deemed sale gain or loss. As mentioned earlier, if the seller had simply treated it as a stock sale, there would be only a capital gain at the shareholder level. Since the deemed asset sale election was made, some of the gain will probably be treated as ordinary income due to depreciation recapture which probably will increase the tax paid by the seller

Stepped up asset basis

The bases of the target corporation assets held by the target after the acquisition date are generally increased to equal the amount paid for the stock plus liabilities of target which carried over. That total amount is allocated to the assets by the "residual" method of IRC Section 1060 which involves first allocating fair market value basis to all "hard assets" such as cash and tangible property. Then, any remaining basis is allocated to general intangible assets such as goodwill and going concern value. Equipment and furniture can generally be depreciated over 7 years using accelerated methods and goodwill or going concern value can be amortized over 15 years. Though the basis of the assets have increased, they still reside in the same target corporation, now owned by the acquiring, so presumably any pre-existing legal issue now becomes the problem of the buyers.

Making the election

The election of Section 338(h)(10) treatment is made on Form 8023 which is due no later than the 15th day of the 9th month beginning after the month in which the acquisition date occurs. Because this date sometimes fell before a corporation's year end, it was one of the most commonly missed elections. For this reason the IRS issued Revenue Procedure 2003-33 granting some relief in the case of missed elections. Form 8883 for allocation of asset basis is generally required to be attached to the tax returns for the sale period.

Conclusion

The election to treat a stock purchase as a deemed asset purchase is useful when a step up in basis of underlying assets is desired or when an actual liquidation of the acquired corporation is not feasible. All the tax advantages accrue to the buyer so the seller should be duly compensated in terms of an increase in sales price. The mechanics and timing of the election are critical and should be carefully managed.

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

IRS PARTLY CAVES IN ON SUCCESS-BASED FEES

The deductibility of "success-based fees" in reorganization transactions has been an area of great controversy between taxpayers and the Internal Revenue Service. Though IRS has generally had the upper hand since its victory in the 1992 INDOPCO case, so much litigation has been generated that IRS recently agreed to allow 70% of success-based fees in certain cases to be deducted as an expense of closing the transaction. The remaining 30% has to be capitalized and in some cases is not deductible.

After the INDOPCO victory, IRS promulgated Regulation 1.263(a)-5 which governs a wide variety of transactions—acquisitions of stock or assets constituting a business, reorganizations (outside of bankruptcy, there are special rules for Ch. 11 reorgs), stock issuances, recapitalizations, formations of corporations or partnerships, borrowings, etc. For an acquirer, the regulation identifies many expenses incurred in a transaction as "facilitating" the transaction, meaning the expense has to be capitalized, as opposed to being currently deducted as an ordinary and necessary business expense. Those expenses which have to be capitalized are then tested in connection with the asset acquired to see if the capitalized amount can be depreciated or amortized for tax purposes. When tangible assets are acquired, some of the capitalized fees are added to the tax basis for depreciation. For amounts borrowed, financing costs are amortized over the life of the loan. However, where capital stock is acquired or an organization is simply restructured, the cost is generally capitalized and no amortization is allowed. The regulation contains a presumption that a success-based fee in an acquisition or reorganization is facilitating and that no amount can be deducted currently unless proven through detailed documentation that it contains some costs which are not facilitating.

In view of the litigation which has embroiled the IRS, it recently announced a "safe harbor election" for acquisitive transactions and reorganizations described in Regulation section 1.263(a)-5(e)(3) where 70% of the success-based fee will be treated as not facilitating and therefore currently deductible and the remaining 30% will be treated as facilitating, i.e. capitalized. Revenue Procedure 2011-29, effective for success-based fees paid or incurred in taxable years ending on or after April 8, 2011.

Commentary

This is a major concession by IRS and one would imagine many taxpayers paying a success-based fee would take advantage of it rather than attempt to get a greater percentage deduction with the required detailed documentation.

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

IRS SETS PROCEDURES FOR DISCHARGE OF LIENS IN SHORT SALES

In October, 2010 the IRS Director of Collection Policy for Small Business and Self Employed issued directions on how IRS is to process certificates of discharge when the sale price of a taxpayer's property subject to an IRS lien is less than the first mortgage obligation on it.

For example, a bank has a priority mortgage claim for $600,000, but, due to the significant decline in the real property market, the bank agrees to a sale of the mortgaged property for $300,000. Because the senior lien attaches to all the equity in the property, generally the lien interest of the IRS in short sale properties is valueless. Nevertheless, the guidance says that applications for

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discharge for properties subject to short sales should be approved under Internal Revenue Code Section 6325(b)(2)(B).

To facilitate the sale of the property in these situations, the senior lien holder (bank) might negotiate the payment of expenses to be taken from its settlement amount. In certain situations, these expenses might be greater than normal closing costs allowed by the IRS and might include creditors that would otherwise be junior to the IRS. This action by the senior lien holder to carve proceeds out of its priority claim to pay these expenses does not create an equity interest on the part of the taxpayer which may be reached by the IRS lien. Provided there is no fraudulent aspect to the payment distribution and the lien interests of the IRS in other properties of the taxpayer is not being harmed, the IRS concedes it has no authority to require payment of the sum that otherwise would have gone to the senior lien holder as illustrated by the following example:

Continuing the previous example, the bank determines that out of the $300,000 sales price, it will allow $15,000 of expenses to be paid. Most of the $15,000 is for normal closing costs, but $5,000 of it is for a homeowner's association fee, which is junior in priority to the IRS, and $2,000 is for state transfer taxes. Because the payments made for the homeowner's association fee and the state transfer taxes are made from proceeds attributable to the bank's priority lien interest and the interest of the IRS in the property to be discharged is valueless, the IRS cannot refuse discharge because of part of the proceeds going to these expenses.

Therefore, upon receiving an application for discharge of a property subject to a short sale, IRS is to follow standard procedures to investigate the statements made in the application regarding the transfer, encumbrances on the property, property values, and proposed distribution of the proceeds. Additional documentation to complete the investigation may be requested if the information has not otherwise been provided. Presuming no issues are identified, the discharge application is to be approved following existing IRS procedures.

The guidance reaffirms that in normal (non-short) sale situations, where the lien claim of the bank is fully paid and the federal tax lien attaches to surplus proceeds, the IRS's lien interest must be satisfied, if possible, before the property can be discharged from the lien. Creditors junior to the IRS interest are not entitled to payment from the proceeds before the IRS lien interest is fully paid. [IRS SBSE Memorandum (SBSE-05-1010-054)]

IRS PROPOSES RULES ON DEBT DISCHARGE TAX TREATMENT OF DISREGARDED ENTITIES

The Internal Revenue Service recently proposed a regulation on the tax treatment of disregarded entities under Internal Revenue Code Section 108 for exclusion of otherwise taxable cancelation of debt income. [proposed Reg. 1.108-9] As a general rule, cancelation of debt income is taxable under IRC Section 61 but Section 108 contains two major exclusions—the "bankruptcy exclusion" and the "insolvency exclusion" which allow taxpayers to escape immediate taxation. In the last 20 years, use of "tax disregarded entities" has become very popular. Disregarded entities are legal entities which are recognized as valid for most state law purposes, primarily limitation of legal liability, but under federal tax law they are ignored and the underlying activities are attributed to the owner. The most common types of tax disregarded entities are "single member limited liability companies", qualified SubChapter S subsidiary corporations and grantor trusts.

There has been some question about how the two major exclusions of Section 108 apply to tax disregarded entities. Since single member limited liability companies, qualified SubChapter S corporation subsidiaries and grantor trusts can file for bankruptcy protection under Title 11, the question becomes whether the two major tax exclusions apply at the entity level or the owner level since the treatment depends in part on the status of the owner. Taking first the "bankruptcy exclusion" under IRC 108(a)(1)(A), income from debts discharged in a Title 11 action can be excluded from current taxable income. Is it sufficient for the disregarded entity, e.g. a single member LLC, to have filed the petition or must the individual or entity owning the LLC have filed A petition too? The proposed regulation concludes that the owner must be in bankruptcy too in order to obtain the exclusion. In the case of the insolvency exclusion of 108(a)(1)(B), likewise, the proposed regulation looks to the balance sheet of the owner, not the underlying entity alone, to determine insolvency.

Where the owner is a partnership, the situation is more complex. You look not only to the owner, the partnership, but then the activities of the partnership must be allocated to the partners. Thus for the insolvency exception, a discharge of indebtedness in a LLC wholly owned by the partnership must be attributed to the partners on some percentage basis and then the partner must be insolvent in order to qualify for the insolvency exception.

Example: Individual partners A, B and C own Partnership Y which owns 100% of LLC X. That LLC defaults on a debt and realizes cancelation of debt income of $100,000. Under the terms of the partnership agreement, $30,000 of the COD income is attributed to Partner A. Partner A must be personally insolvent to take advantage of excluding any COD income under 108(a)(1)(B). Otherwise, A will be taxable on the $30,000.

Commentary:

The position the IRS takes make sense and though I usually don't welcome IRS guidance because it is often unduly restrictive, in this area it is helpful as it makes the 108 regime consistent with the treatment of disregarded entities for other tax purposes. ■

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

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

Bankruptcy Cases

Baxter Dunaway

CLASS ACTIONS/ARBITRATION

Supreme Court

May businesses use standard-form contracts to forbid consumers claiming fraud from banding together in a single arbitration?

The Supreme Court ruled 5-4 that businesses may use standard-form contracts to forbid consumers claiming fraud from banding together in a single arbitration[1], the *New York Times* reported.[2] Though the decision concerned arbitrations, it appeared to provide businesses with a way to avoid class-action lawsuits in court. All they need do, the decision suggested, is to use standard-form contracts that require two things: that disputes be raised only through the informal mechanism of arbitration and that claims be brought individually. "The decision basically lets companies escape class actions, so long as they do so by means of arbitration agreements," Brian T. Fitzpatrick, a law professor at Vanderbilt University, said. "This is a game-changer for businesses. It's one of the most important and favorable cases for businesses in a very long time."[3] The decision is in accord with recent cases that have favored arbitrations and been alert to aspects of class actions.

The Supreme Court's decision is not limited to arbitration agreements in consumer contracts and, therefore, may have significant implications for arbitration provisions in all forms of contracts, including employment and residential consumer sales. Companies should review their contracts in light of the Court's decision to determine whether to include arbitration provisions containing class action waivers.[4]

Justice Antonin Scalia, writing for the majority said that the lower courts had failed to properly apply the Federal Arbitration Act, which overrides some state court decisions disfavoring arbitration. The California Supreme Court decision had barred class waivers in all standard-form contracts, whether applicable to arbitrations or court proceedings, as unconscionable if they gave rise to claims that the companies issuing them had set out "to deliberately cheat large numbers of consumers out of individually small amounts of money."[5]

The American Banker cautions:

> While such a decision [AT&T decision] might normally put the issue to rest, the Dodd-Frank Act[6] requires the CFPB [Consumer Financial Protection Bureau] to study and provide a report to Congress concerning the use of mandatory arbitration agreements in connection with consumer financial products. It also allows the agency to issue rules that may "prohibit or impose conditions" on the use of arbitration agreements if the study finds that it would be in the public interest and would protect consumers. [7]

The distinction is critical, because while the Supreme Court case said arbitration clauses are binding once they are part of a contract, the CFPB may still be able to prohibit their inclusion in a contract to begin with.

"What it begs is the question of whether a regulator can prohibit the use of a mandatory arbitration clause," said Andrew Sandler, a partner in BuckleySandler LLP. "What this says is when [the clause] is in the contract, it's effective and you can't have class action. Now the question is can a regulator mandate that you're not allowed to put these clauses in a contract. So that's the next issue probably."[8]

Syllabus

*1 The cellular telephone contract between respondents (Concepcions) and petitioner (AT & T) provided for arbitration of all disputes, but did not permit classwide arbitration. After the Concepcions were charged sales tax on the retail value of phones provided free under their service contract, they sued AT & T in a California Federal District Court. Their suit was consolidated with a class action alleging, inter alia, that AT & T had engaged in false advertising and fraud by charging sales tax on "free" phones. The District Court denied AT & T's motion to compel arbitration under the Concepcions' contract. Relying on the California Supreme Court's Discover Bank decision, it found the arbitration provision unconscionable because it disallowed classwide proceedings. The Ninth Circuit agreed that the provision was unconscionable under California law and held that the Federal Arbitration Act (FAA), which makes arbitration agreements "valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract," 9 U.S.C. § 2, did not preempt its ruling.

Bankruptcy Cases *continues on p. 12*

1 AT&T Mobility LLC v. Concepcion, --- S.Ct. ----, 2011 WL 1561956 (U.S. Apr 27, 2011) (NO. 09-893).

2 John Hartgen, Supreme Court Authorizes Contracts That Prohibit Class-Action Arbitration, ABI Bankruptcy Brief(Apr. 28, 2011); Adam Liptak, Supreme Court Allows Contracts That Prohibit Class-Action Arbitration, 4/28/11 N.Y. Times B3, 2011 WLNR 8221189.

3 Adam Liptak, Supreme Court Allows Contracts That Prohibit Class-Action Arbitration, 4/28/11 N.Y. Times B3, 2011 WLNR 8221189.

4 Dwayne P. McKenzie & Charles E. Noneman, U.S. Supreme Court Upholds Class Action Waivers In Arbitration Agreements - How This Ruling May Impact Arbitration Provisions In Your Employment, Sales And Other Agreements (Cox, Castle & Nicholson, Client Alert, May 2, 2011).

5 John Hartgen, Supreme Court Authorizes Contracts That Prohibit Class-Action Arbitration, ABI Bankruptcy Brief (Apr. 28, 2011).

6 Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub.L. 111–203, July 21, 2010, 124 Stat. 1376.

7 See generally, Bingham McCutchen, Dodd Frank Reform & Consumer Protection Act Ch2, P. 23 (Westlaw citation: PLIREF-DFREF CH 2):

- The Consumer Financial Protection Bureau is authorized to prohibit or impose conditions or limitations on mandatory pre-dispute arbitration clauses between any person offering or providing a consumer financial product or service and a consumer in connection with the offering or providing of consumer financial products or services.
- Bureau is also directed to conduct a study of, and to report to Congress concerning, the use of mandatory pre-dispute arbitration agreements in offering or providing of consumer financial products or services.

8 Kate Davidson, High Court Gives Banks A Win, But Will It Last?, American Banker, Volume 176; Issue 66, 4/28/11 AMBKR 1 (April 28, 2011)(footnotes added).

Bankruptcy Cases *continues from p. 11*

Held: Because it "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress," Hines v. Davidowitz, 312 U.S. 52, 67, 61 S.Ct. 399, 85 L.Ed. 581, California's Discover Bank rule is pre-empted by the FAA. Pp. —— – ——.

(a) Section 2 reflects a "liberal federal policy favoring arbitration," Moses H. Cone Memorial Hospital v. Mercury Constr. Corp., 460 U.S. 1, 24, 103 S.Ct. 927, 74 L.Ed.2d 765, and the "fundamental principle that arbitration is a matter of contract," Rent–A–Center, West, Inc. v. Jackson, 561 U.S. ——, ——, 130 S.Ct. 2772, 177 L.Ed.2d 403 (2010). Thus, courts must place arbitration agreements on an equal footing with other contracts, Buckeye Check Cashing, Inc. v. Cardegna, 546 U.S. 440, 443, 126 S.Ct. 1204, 163 L.Ed.2d 1038, and enforce them according to their terms, Volt Information Sciences, Inc. v. Board of Trustees of Leland Stanford Junior Univ., 489 U.S. 468, 478, 109 S.Ct. 1248, 103 L.Ed.2d 488. Section 2's saving clause permits agreements to be invalidated by "generally applicable contract defenses," but not by defenses that apply only to arbitration or derive their meaning from the fact that an agreement to arbitrate is at issue. Doctor's Associates, Inc. v. Casarotto, 517 U.S. 681, 687, 116 S.Ct. 1652, 134 L.Ed.2d 902. Pp. —— – ——.

(b) In Discover Bank, the California Supreme Court held that class waivers in consumer arbitration agreements are unconscionable if the agreement is in an adhesion contract, disputes between the parties are likely to involve small amounts of damages, and the party with inferior bargaining power alleges a deliberate scheme to defraud. Pp. —— – ——.

(c) The Concepcions claim that the Discover Bank rule is a ground that "exist[s] at law or in equity for the revocation of any contract" under FAA § 2. When state law prohibits outright the arbitration of a particular type of claim, the FAA displaces the conflicting rule. But the inquiry is more complex when a generally applicable doctrine is alleged to have been applied in a fashion that disfavors or interferes with arbitration. Although § 2's saving clause preserves generally applicable contract defenses, it does not suggest an intent to preserve state-law rules that stand as an obstacle to the accomplishment of the FAA's objectives. Cf. Geier v. American Honda Motor Co., 529 U.S. 861, 872, 120 S.Ct. 1913, 146 L.Ed.2d 914. The FAA's overarching purpose is to ensure the enforcement of arbitration agreements according to their terms so as to facilitate informal, streamlined proceedings. Parties may agree to limit the issues subject to arbitration, Mitsubishi Motors Corp. v. Soler Chrysler–Plymouth, Inc., 473 U.S. 614, 628, 105 S.Ct. 3346, 87 L.Ed.2d 444, to arbitrate according to specific rules, Volt, supra, at 479, 109 S.Ct. 1248, and to limit with whom they will arbitrate, Stolt–Nielsen, supra, at ——. Pp. —— – ——.

*2 (d) Class arbitration, to the extent it is manufactured by Discover Bank rather than consensual, interferes with fundamental attributes of arbitration. The switch from bilateral to class arbitration sacrifices arbitration's informality and makes the process slower, more costly, and more likely to generate procedural morass than final judgment. And class arbitration greatly increases risks to defendants. The absence of multilayered review makes it more likely that errors will go uncorrected. That risk of error may become unacceptable when damages allegedly owed to thousands of claimants are aggregated and decided at once. Arbitration is poorly suited to these higher stakes. In litigation, a defendant may appeal a certification decision and a final judgment, but 9 U.S.C. § 10 limits the grounds on which courts can vacate arbitral awards. Pp. —— – ——.

584 F.3d 849, reversed and remanded.

SCALIA, J., delivered the opinion of the Court, in which ROBERTS, C. J., and KENNEDY, THOMAS, and ALITO, JJ., joined. THOMAS, J., filed a concurring opinion. BREYER, J., filed a dissenting opinion, in which GINSBURG, SOTOMAYOR, and KAGAN, JJ., joined.

BANKRUPTCY

Supreme Court

Must a debtor have a car payment due in order to deduct such an expense when running the means test?

Supreme Court holds that a debtor must have a car payment due in order to deduct such an expense when running the means test. Ransom v. FIA Card Services, N.A., 131 S.Ct. 716, 178 L.Ed.2d 603, 64 Collier Bankr.Cas.2d 1123, Bankr. L. Rep. P 81,914, 11 Cal. Daily Op. Serv. 459, 2011 Daily Journal D.A.R. 509, 22 Fla. L. Weekly Fed. S 737 (U.S. Jan 11, 2011).

Syllabus

Chapter 13 of the Bankruptcy Code uses a statutory formula known as the "means test" to help ensure that debtors who can pay creditors do pay them. The means test instructs a debtor to determine his "disposable income"-the amount he has available to reimburse creditors-by deducting from his current monthly income "amounts reasonably necessary to be expended" for, inter alia, "maintenance or support." 11 U.S.C. § 1325(b)(2)(A)(i). For a debtor whose income is above the median for his State, the means test indentifies which expenses qualify as "amounts reasonably necessary to be expended." As relevant here, the statute provides that "[t]he debtor's monthly expenses shall be the debtor's applicable monthly expense amounts specified under the National Standards and Local Standards, and the debtor's actual monthly expenses for the categories specified as Other Necessary Expenses issued by the Internal Revenue Service [IRS] for the area in which the debtor resides." § 707(b)(2)(A)(ii)(I).

The Standards are tables listing standardized expense amounts for basic necessities, which the IRS prepares to help calculate taxpayers' ability to pay overdue taxes. The IRS also creates supplemental guidelines known as the "Collection Financial Standards," which describe how to use the tables and what the amounts listed in them mean. The Local Standards include an allowance for transportation expenses, divided into vehicle "Ownership Costs" and vehicle "Operating Costs." The Collection Financial Standards explain that "Ownership Costs" cover monthly loan or lease payments on an automobile; the expense amounts listed are based on nationwide car financing data. The Collection Financial Standards further state that a taxpayer who has no car payment may not claim an allowance for ownership costs.

Bankruptcy Cases *continues on p. 13*

Bankruptcy Cases *continues from p. 12*

When petitioner Ransom filed for Chapter 13 bankruptcy relief, he listed respondent (FIA) as an unsecured creditor. Among his assets, Ransom reported a car that he owns free of any debt. In determining his monthly expenses, he nonetheless claimed a car-ownership deduction of $471, the full amount specified in the "Ownership Costs" table, as well as a separate $388 deduction for car-operating costs. Based on his means-test calculations, Ransom proposed a bankruptcy plan that would result in repayment of approximately 25% of his unsecured debt. FIA objected on the ground that the plan did not direct all of Ransom's disposable income to unsecured creditors. FIA contended that Ransom should not have claimed the car-ownership allowance because he does not make loan or lease payments on his car. Agreeing, the Bankruptcy Court denied confirmation of the plan. The Ninth Circuit Bankruptcy Appellate Panel and the Ninth Circuit affirmed.

Held: A debtor who does not make loan or lease payments may not take the car-ownership deduction. Pp. 723 - 730.

(a) This Court's interpretation begins with the language of the Bankruptcy Code, which provides that a debtor may claim only "applicable" expense amounts listed in the Standards. Because the Code does not define the key word "applicable," the term carries its ordinary meaning of appropriate, relevant, suitable, or fit. What makes an expense amount "applicable" in this sense is most naturally understood to be its correspondence to an individual debtor's financial circumstances. Congress established a filter, permitting a debtor to claim a deduction from a National or Local Standard table only if that deduction is appropriate for him. And a deduction is so appropriate only if the debtor will incur the kind of expense covered by the table during the life of the plan. Had Congress not wanted to separate debtors who qualify for an allowance from those who do not, it could have omitted the term "applicable" altogether. Without that word, all debtors would be eligible to claim a deduction for each category listed in the Standards. Interpreting the statute to require a threshold eligibility determination thus ensures that "applicable" carries meaning, as each word in a statute should.

This reading draws support from the statute's context and purpose. The Code initially defines a debtor's disposable income as his "current monthly income ... less amounts reasonably necessary to be expended." § 1325(b)(2). It then instructs that such reasonably necessary amounts "shall be determined in accordance with" the means test. § 1325(b)(3). Because Congress intended the means test to approximate the debtor's reasonable expenditures on essential items, a debtor should be required to qualify for a deduction by actually incurring an expense in the relevant category. Further, the statute's purpose-to ensure that debtors pay creditors the maximum they can afford-is best achieved by interpreting the means test, consistent with the statutory text, to reflect a debtor's ability to afford repayment. Pp. 723 - 725.

(b) The vehicle-ownership category covers only the costs of a car loan or lease. The expense amount listed ($471) is the average monthly payment for loans and leases nationwide; it is not intended to estimate other conceivable expenses associated with maintaining a car. Maintenance expenses are the province of the separate "Operating Costs" deduction. A person who owns a car free and clear is entitled to the "Operating Costs" deduction for all driving-related expenses. But such a person may not claim the "Ownership Costs" deduction, because that allowance is for the separate costs of a car loan or lease. The IRS' Collection Financial Standards reinforce this conclusion by making clear that individuals who have a car but make no loan or lease payments may take only the operating-costs deduction. Because Ransom owns his vehicle outright, he incurs no expense in the "Ownership Costs" category, and that expense amount is therefore not "applicable" to him. Pp. 725 - 726.

(c) Ransom's arguments to the contrary-an alternative interpretation of the key word "applicable," an objection to the Court's view of the scope of the "Ownership Costs" category, and a criticism of the policy implications of the Court's approach-are unpersuasive. Pp. 726 - 730.

577 F.3d 1026, affirmed. KAGAN, J., delivered the opinion of the Court, in which ROBERTS, C.J., and KENNEDY, THOMAS, GINSBURG, BREYER, ALITO, and SOTOMAYOR, JJ., joined. SCALIA, J., filed a dissenting opinion.

References:

What constitutes "disposable income" under sec. 1325(b) of Bankruptcy Code of 1978 (11 U.S.C.A. sec. 1325(b)), providing that all disposable income for specified period must be applied to plan for payment of creditors, 138 A.L.R. Fed. 547 (1997).

Consumer Bankruptcy Handbook with Forms § 2:3, Evaluating debtor's need for relief under Bankruptcy Code-Means test calculations-How it is applied (2011).

2011 Norton Bankruptcy Law Adviser 1, Projected Disposable Income Captures the Attention of the Supreme Court-Twice! (2011).

The Supreme Court Interprets the Means Test, 30-APR Am. Bankr. Inst. J. 18, 18+ (2011).

Third Circuit

In a dysfunctional market, what is a "commercially reasonable determinant of value" under 11 U.S.C.A. § 562 for measuring damages from the acceleration of a debtor's agreement to repurchase a mortgage loan portfolio it had sold?

The case involved a claim by investment bank Calyon, now known as Credit Agricole Corporate & Investment Bank, against American Home Mortgage resulting from a default on a 2006 repurchase agreement.

The Third Circuit holds that the discounted cash flow (DCF) method was a "commercially reasonable determinant of value" for measuring damages from the acceleration of a debtor's agreement to repurchase a mortgage loan portfolio it had sold. The secondary mortgage market was dysfunctional on the acceleration date, so that it would not have been reasonable to sell the portfolio. In re American Home Mortg. Holdings, Inc., --- F.3d ----, 2011 WL 522945, Bankr. L. Rep. P 81,940 (3rd Cir. (Del.) Feb 16, 2011) (NO. 09-4295)

Bankruptcy Cases *continues on p. 14*

Bankruptcy Taxes *continues from p. 13*

A repurchase agreement, often referred to as a "repo agreement," is defined in § 101(47) of the Bankruptcy Code as "an agreement, including related terms," that (1) "provides for the transfer of one or more ... mortgage loans, [or] interests in mortgage related securities or mortgage loans[;]" (2) "against the transfer of funds by the transferee of such ... mortgage loans, or interests[;]" (3) "with a simultaneous agreement by such transferee to transfer to the transferor thereof ... mortgage loans, or interests [in mortgage related securities or mortgage loans;]" (4) "at a date certain not later than 1 year after such transfer or on demand[;]" (5) "against the transfer of funds[.]" In simple words, the purchaser of an asset promises to sell it back at the time fixed or when asked. Repurchase Agreements are among the transactions governed by § 562 of the Bankruptcy Code which was enacted as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"), Pub.L. No. 109-8, § 910, 119 Stat. 23, 184 (2005), described by Congress as "a comprehensive package of reform measures pertaining to both consumer and business bankruptcy cases." H.R.Rep. No. 109-31, at 2 (2005).

Pursuant to a Repurchase Agreement, a purchaser Calyon purchased approximately 5,700 mortgage loans with an original unpaid principal balance of just under $1.2 billion. The mortgage properties were located in all fifty states of the United States. The portfolio was principally comprised of adjustable rate mortgages and pay option adjustable rate mortgages, as well as a small portion of Government conforming loans and second lien loans.

The Court of Appeals panel said the Bankruptcy Court properly credited Clayton's testimony to find that a DCF analysis is a "commercially reasonable methodology" and that the DCF analysis resulted in no deficiency claim as of the acceleration date.

Research References: Bankruptcy Law Manual 5d §§ 2:4, 8:1, 8:38, 8:41; 16 Westlaw Journal Securities Litigation & Regulation 2, No Claim Against Bankrupt Lender Over Repo Deal Default, 3rd Circuit Says (2011). ■

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

"The Annual Conference in Boston this year was fully in keeping with AIRA's high standards. For those of you who could not attend, I am sorry that you missed a great opportunity..."
—President Steve Darr

AIRA President, Stephen Darr, CIRA, CDBV (Mesirow Financial Consulting LLC, Boston MA), presided over Thursday's opening program and the Annual Banquet and Awards Ceremony.

President Elect, Anthony "Tony" Sasso, CIRA (Deloitte Financial Advisory Services LLP, New York NY), acted as presiding officer introducing moderators and panels.

27th Annual Bankruptcy & Restructuring Conference Highlights, cont.

Keynote speaker Charles D. Baker, Jr., candidate for governor of Massachusetts in 2010, addressed Thursday's opening session on "Tactics in Healthcare Organization Turnarounds."

At Friday's luncheon program, James R. Wigand, Director of FDIC's Office of Complex Financial Institutions, presented "Dodd Frank: How the Provisions Will Be Impemented."

Featured speaker at Wednesday's Preconference Lunch Program, Daniel M. Glosband (Partner, Goodwin Procter) spoke on "Madoff: Customer Claims and Customer Liability."

Hon. Rosemary Gambardella (at right) will receive AIRA's 2011 Judicial Service Award at the New York POR Conference on November 14, 2011.

CONFERENCE ATTENDEE EVALUATIONS:

"Great that we get such high-level speakers!"
"Small business sessions are very good, even if you only work on larger cases."

"Keep doing the small business track."
"Enjoyable Ethics session. Good advice from wise advisors."

27th Annual Conference Highlights, cont.

Boston social activities were a big hit—among the offerings were the events pictured clockwise from upper left: Kayaking Excursion on the Charles River; Pinehills Rees Jones Golf Course (golf sponsor, AlixPartners; drink cart sponsor, Burr & Forman LLP); and Thompson Island Lobster/Clambake (sponsored by PCG Consultants). Other social activities were Legal Seafood Gourmet Test Kitchen, Duck Boat Tour, Freedom Trail, and the traditional 5K Run/Walk (sponsor, ArentFox LLP).

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Zolfo Cooper

27th Annual Conference Highlights, cont.

THANK YOU TO CONFERENCE CO-CHAIRS AND PLANNING COMMITTEE

AIRA is grateful for the leadership of Co-Chairs Paul Moore (upper left, with Charlie Baker), Eric Danner (upper right), and Sheila Smith (lower right, with past President Grant Stein), and extends sincerest thanks to all committee members and speakers for working to make the Boston conference a success.

Both preconference seminars and the general conference program, with 26 expert presentations and technical sessions, were very well attended and received excellent evaluations from participants.

NEW CIRAS

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Oak Park, IL

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San Francisco, CA

Jennifer Byrne
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CLUB 10

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AlixPartners, LLP	**60**
KPMG LLP	**34**
Grant Thornton LLP	**31**
Huron Consulting Group LLC	**26**
Capstone Advisory Group, LLC	**25**
Zolfo Cooper	**25**
Loughlin Meghji + Company	**24**
Mesirow Financial Consulting LLC	**21**
Deloitte Financial Advisory Services LLP	**21**
Conway MacKenzie, Inc.	**17**
Protiviti Inc	**16**
Navigant Capital Advisors LLC	**16**
BDO Consulting	**16**
PricewaterhouseCoopers LLP	**15**
Ernst & Young LLP	**12**
CRG Partners Group LLC	**12**
Office of the U.S. Trustee	**10**

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