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Journal

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Gavin/Solmonese LLC

Market Evidence vs. Expert Opinion: And the Winner Is . . .

Proponents of the use of "market" evidence in valuation litigation have pointed to decisions such as VFB LLC v. Campbell Soup Co., Iridium Operating LLC v. Motorola, Inc. and In re Old Carco LLC to argue that courts should defer to the "market" over expert opinion, including cases where the corporation being valued lacks publicly traded securities. In addition to market prices, the types of market evidence suggested consist of the actions and views of the subject firm's executives, creditors, investors and expert advisors on or around the valuation date. However, in the December 12, 2013 opinion of the U.S. Bankruptcy Court for the Southern District of New York in the case of Tronox Inc. v. Kerr McGee Corp. et al, such "market" evidence was rejected in essence due to lack of relevance and reliability based on the underlying facts and interpretations thereof expressed in expert opinion.

Kerr-McGee Corporation was at year-end 2005 one of the largest U.S.-based independent oil and natural gas exploration and production companies, with $5.9 billion in revenue and nearly 1 billion barrels of oil equivalent proven reserves. Accordingly, as part of a strategic restructuring initiated in 2000, in October 2005 the Board approved the spin-off of its chemical business, Tronox, through an IPO, to be followed by a distribution of its remaining interest in a stock dividend. The IPO was executed in November 2005, along with an issue of unsecured notes and a term loan. The proceeds of the financings, which came to about $775 million, together with existing cash in excess of $40 million, were distributed to Kerr-McGee. The Board subsequently declared a dividend of Tronox's Class B common stock on March 8, 2006, which in effect transferred ownership of Tronox to its shareholders, along with its environmental liabilities and those of the oil and gas business retained by Kerr-McGee. Further, Kerr-McGee required Tronox to assume $442 million in pension obligations and $186 million in unfunded other post-employment benefits.

Tronox experienced financial difficulties subsequent to the spin-off, and in January 2009 filed for Chapter 11. Confirmed in November 2010, Tronox' s First Amended Joint Plan of Reorganization established the Anadarko Litigation Trust to pursue claims against Anadarko Petroleum Corporation and its subsidiaries, including Kerr McGee. In its complaint, the Trust alleged that Tronox was left with "70 years and billions of dollars of legacy environmental and tort liabilities when the oil and gas assets of the group were transferred out and spun off; that the transfer was designed to hinder, delay or defraud creditors, ….that it left the Debtors insolvent and undercapitalized."

Noting that the analysis of fraudulent transfers should focus on substance over form, the Court found that the sequence of transactions that was initiated in 2000 and culminated with the spin-off of Tronox in 2005 and 2006 should be collapsed for statute of limitations purposes. Further, the Court concluded that the transfers were actually fraudulent in view of Defendants' clear intent to hinder or delay creditors. Addressing the question of whether the transfers were constructively fraudulent, the Court began with an examination of whether Tronox received reasonably equivalent value in exchange.

Plaintiffs' expert testified that Tronox had transferred assets worth approximately $17 billion and received assets worth $2.6 billion in return. Defendants chose not to file a rebuttal expert report, object to the Plaintiffs' expert's calculations or dispute that Tronox had transferred billions of dollars more than it received, however. Instead, Defendants maintained that the transfer of E&P assets should be excluded based on statutes of limitations, that the conversion of an intercompany account from debt to equity should be recognized at face value as a $377.9 million contribution to Tronox, and that reasonably equivalent value and solvency should be analyzed entity-by-entity. The Court rejected each of

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A Letter From the President

Anthony V. Sasso, CIRA
Deloitte CRG

Hello, fellow members and friends of the AIRA. On a personal note, I am coming off a busy stretch, fortunate enough to work on the American Airlines case. Given its size and highly successful result for virtually all constituents, it was an exciting change of pace in a market not as robust with restructuring activity as many of us would have hoped. Hopefully many of you have had an equally busy and enjoyable winter season.

As we look forward to celebrating the AIRA's 30th Annual Bankruptcy and Restructuring Conference at the Westin Denver Downtown on June 4– 7, my presidency is coming to an end, and I will be handing over the reins to our President Elect, Matt Schwartz. Matt has devoted many years to the AIRA Board and we look forward to his leadership through another successful chapter for the AIRA.

As I write my last letter and look back over the past two years, I would like to mention just a couple of the highlights of my tenure:

- Last year at the Annual Banquet and Awards dinner we announced the **AIRA Grant Newton Educational Endowment Fund.** Matt Schwartz, Gina Gutzeit, Joel Waite, Grant Stein and other Board members donated a significant amount of time and effort to work through the legal process and other details, along with spearheading the initial fundraising effort, and it is off to a great start.
- The other item I would like to highlight is the newly established **AIRA Valuation Standards.** A committee led by Tom Morrow, our incoming President-Elect, along with Board members David Bart and David Payne and Executive Director Grant Newton, made significant contributions to bring this project to the finish line. David Payne will lead a panel discussing how these new standards interact with various perspectives and rulings from the Bench at the Annual Conference in Denver on June 6th.

Continuing with the subject of our Annual Conference, I would like to thank **Conference Chairs,** Chris LeWand of FTI Consulting, Michael Pancow of Brownstein Hyatt Farber Schrek, and Peter Schulman of RubinBrown, along with the **Planning Committee**, for their hard work in putting together a great program.

Some additional conference highlights:

- Keynote Speakers this year include Colorado Governor John Hickenlooper (invited); Dianne Barrett, Chief Projects Officer of the City & County of Denver; and Tom Binnings, Senior Partner of Summit Economics.
- In the international arena we are seeing a rise in US exports, companies for sale and flows of funds to new deals. These activities along with struggling economies abroad hold promise for U.S. practitioners focusing on international restructuring. My colleague Sheila Smith, who co-leads our restructuring practice in the U.S. and leads our cross-border restructuring practice in the Americas, will share the spotlight with a distinguished panel of experts to discuss "Restructuring Across Jurisdictions" on Friday, June 6.
- Other topics, such as the Restructuring Outlook; China's Economic Slowdown; CRO Services; Ponzi Schemes; Issues in Media; and the many others, should provide something for everyone and make for a great educational experience overall.

In closing, I would like to thank Grant Newton, his wife and assistant Valda, the entire Board and all of the AIRA staff for their support over the last two years.

Best to all, and we hope to see you at the Conference in June,

Tony Sasso

Anthony Sasso

Executive Director's Column

Grant Newton, CIRA
Aira, Executive Director

First Circuit Rules on Postpetition Interest to Oversecured Lender

On April 11, 2014, in In re SW Boston Hotel Venture LLC, the Court of Appeals for the First Circuit reversed a ruling by the Bankruptcy Appellate Panel ("BAP"), reinstated the plan of reorganization for SW Boston Hotel Venture LLC and its affiliates, and rejected Prudential Insurance Company's demand for $25 million in post-petition interest. Two key questions were addressed: 1) when does an oversecured chapter 11 creditor's claim for post-petition interest begin to accrue, and 2) how should such post-petition interest be calculated?

SW's project consisted of a 235-room hotel, 123 luxury condos, parking garage, restaurant, bar, spa and retail space. The hotel opened in October 2009 but condo sales did not meet projections and the restaurant, spa, and bar were still not completed in April 2010. At this time, SW failed to make a mandatory quarterly payment to Prudential, its senior secured creditor, and shortly thereafter filed a chapter 11 petition. Prudential had provided $192 million in financing to build the project. Soon after the petition was filed, Prudential sought relief from the stay to foreclose on its collateral; however the Bankruptcy Court denied such relief, finding Prudential was adequately protected. SW continued construction, sold additional units and paid a portion of proceeds to Prudential. In the spring of 2011, SW obtained Bankruptcy Court approval to sell the hotel and garage to a third party for $89.5 million, $88.3 million of which was paid to Prudential. SW then filed a proposed plan under which Prudential would receive the remaining portion of its claim; however, interest was not included for the period from the petition date to the effective date of the confirmed plan. Prudential objected and filed a motion seeking determination that it was oversecured and thus entitled to postpetition interest at the contractual default rate of 14.5%. SW argued that Prudential became oversecured when the sale occurred, and thus postpetition interest started on the sale date not the petition date. SW also argued that postpetition interest should be calculated at the contractual non-default rate of 9.5%.

The Bankruptcy Court agreed with SW as to timing but sided with Prudential as to calculation, confirming SW's proposed plan over Prudential's objection. Prudential appealed to the BAP which reversed the Bankruptcy Court on the timing issue and ruled Prudential was entitled to post-petition interest from the petition date at the contractual default rate of 14.5%, compounded according to contract terms.

Post-petition interest is not generally allowed after the filing of a bankruptcy petition under Section 502(b)(2) of the Bankruptcy Code; however, there is an exception for oversecured creditors, who are entitled to post-petition interest up to the value of their collateral. Courts have been split on the issue of when such postpetition interest starts to accrue. Some courts including the Eleventh Circuit Court of Appeals have held that a creditor's allowed secured claim for post-petition interest is limited to the amount that the creditor was oversecured at the time of filing. Other courts take a more flexible approach, based on the fact that Section 506(b) does not define the measuring date for purposes of post-petition interest, noting that Section 506(a) says the value of collateral will be determined "in light of the purpose of the valuation and of the proposed disposition or use of the property." The First Circuit concluded that the Bankruptcy Court's flexible approach appropriately considered the facts and circumstances of the case including improvements after the petition date, and accordingly upheld the Bankruptcy Court's decision granting postpetition interest only from the date of the sale.

Just as it does not indicate the date on which postpetition interest for oversecured claims begins to accrue, the Bankruptcy Code is also silent on how to calculate such interest. In SW Boston Hotel, the First Circuit adopts the general approach that contractual interest rate terms apply so long as they are enforceable and equitable. The First Circuit accepts the contractual default rate of 14.5%; however, reverses the BAP on compounding interest, because although Prudential's loan agreement explicitly provided for compounding, Prudential did not request compounding until after the Bankruptcy Court issued its ruling on the interest calculation.

The First Circuit's opinion in SW Boston Hotel presents a cogent examination of issues arising from the financing of a large real estate development. Regarding the timing and calculation of postpetition interest, the decision highlights flexibility and judicial discretion under the Bankruptcy Code, and the value of reasonable expectations during negotiations. It also demonstrates that a lender's right to post-petition interest may change during the course of the bankruptcy case.

Thank You to Baxter Dunaway and Tony Sasso

Over 30 years ago, just after I started to teach at Pepperdine, I met Baxter Dunaway, a Pepperdine Law School professor. Since then, Baxter and I have enjoyed working together on many issues related to bankruptcy and troubled business including real estate. Although Baxter retired from Pepperdine some years past, he continued until now to serve as author and section editor for the Bankruptcy Cases column in AIRA Journal. The Board of Directors of AIRA and I are grateful for the countless hours he spent summarizing and analyzing cases relevant to AIRA members. We extend our thanks and best wishes to Baxter and his wife Deon.

I also thank Tony Sasso for serving as AIRA's president for the past two years. It has been a real honor and a pleasure to work with Tony. He has devoted a lot of time to AIRA, not just during the past two years but long before he assumed the role of President. We are grateful to his wife and three sons for sharing Tony with us during the past two years.

At the Annual Conference in Denver, June 4-7, President-Elect Matthew Schwartz, who served as Treasurer for many years, will assume the duties of AIRA's President. I look forward to working with Matt in the coming months. In closing, I highly recommend that if you have not already registered for AIRA's 30th Annual Conference, you should go to www.aira.org and sign up now!

Best regards,

Grant

Grant Newton

Market Evidence *continued from pg. 1*

these arguments in finding, as did Plaintiffs' expert, that Tronox received $17 billion in return for assets worth $2.6 billion on a consolidated basis.

The Court considered next whether Tronox was solvent based on the balance sheet test, examining whether the sum of Tronox's debts was greater than all of its assets at a fair valuation as implied by market evidence. To start with, the Court found that since the $450 million in debt raised by Tronox at the time of its IPO was secured by all of its assets, Defendants' reliance on this market evidence was not creditable since those who bought the debt knew they would have priority in a bankruptcy. Further, the Court found that Plaintiffs' expert showed that the IPO financial statements relied on by the markets were false and misleading, and that the financial statements as prepared omitted relevant contingencies and potential liabilities. Notwithstanding, the Court concluded that Plaintiffs did not need to prove that the IPO financial statements were unreliable to overcome the market efficiency hypothesis since the issue related not to Tronox's earning power but to the legacy liabilities transferred from Kerr-McGee, which no one on either side maintained were adequately reserved for or disclosed for purposes of analyzing solvency.

Defendants' market-evidence defense similarly relied on the investment and financing decisions of Apollo Investors and investment banks JP Morgan, Credit Suisse First Boston and Lehman Brothers, each of whom conducted due diligence on non-public information. With respect to the banks, the Court found that their interests were unique and not indicative of "the market" since they had provided credit to Tronox in a facility secured by all of its assets and therefore expected to be paid in full. Each bank had also been paid millions of dollars by Kerr-McGee, or expected to receive similar fees from financing any Apollo offer. Moreover, none of the banks had valued Tronox's environmental or tort liabilities independently, and Defendants were unable to link the diligence performed by the banks with any independent insight regarding the legacy liabilities. The Court also rejected Defendants' assertion that Apollo's bid to acquire Tronox for $1.3 billion just before the IPO indicated that Tronox was solvent since Apollo never made a final and binding offer, its analysis of environmental and tort liabilities was materially understated and not comprehensive, and its analysis was limited to an assessment of whether it could manage the liabilities, and as such did not represent the basis for a solvency analysis.

The remaining leg of Defendants' market defense was that the contemporaneous statements and actions of Tronox's management represented evidence of solvency. The Court rejected this assertion, however, reasoning that management's efforts to continue operating the firm, and their belief that they could do so, did nothing to prove or disprove Tronox' s solvency. And though observing that many of Tronox' s employees were optimistic regarding its prospects while others saw failure, the Court concluded that the enthusiasm of certain Tronox employees offered no better indication of its solvency than the discouragement of others.

Proceeding from its rejection of Defendants' market evidence-based balance sheet test defense, the Court reasoned there was no substitute under Oklahoma's UFTA for analyzing the fair value of Tronox' s assets and liabilities. In this regard, the Court observed that while the parties did not differ for most of Tronox's liabilities, they did so widely in valuing its environmental and tort liabilities. But noting that Plaintiffs' expert's analysis of environmental liabilities was the only comprehensive valuation, and that the testimony of Defendants' tort expert was not credible, the Court rejected Defendants' experts' testimony and determined that the fair value of Tronox' s total liabilities was $2,073,000,000.

The Court also relied on Plaintiffs' expert's solvency analysis in determining that the fair value of Tronox's assets was $1,223,000,000, and as compared to the value of its liabilities of $2,073,000,000, found that Tronox was insolvent by $850,000,000 on the date of its IPO. The flaws identified by the Court in Defendants' expert's report included that he used Tronox's projections in his discounted cash flow valuation absent further analysis despite facts established by Plaintiffs' expert that they were inflated, overly optimistic and biased by key numbers ordered by the CFO of Kerr-McGee, and that the 15 comparable companies in his comparable company analysis were selected according to whether potential acquirers or industry analysts viewed the companies comparable to Tronox absent any independent analysis of his own.

Considering then if Tronox was left with unreasonably small capital, meaning "a general inability to generate enough cash flow to sustain operations" under the UFTA, the Court found based on Plaintiffs' expert's analysis that Tronox's capital was inadequate for reasons that its projections were unreasonable and overly optimistic, and that Kerr-McGee caused Tronox to upstream all the proceeds from its financing at the time of its IPO. Consequently, Tronox was left with only $40 million in cash despite having to operate in a declining market with poor plants, significant capital expenditures, and no comprehensive business plan while struggling to cut costs.

In contrast, Defendants' expert's capital adequacy analysis relied on downside and worst case projections prepared by independent third parties that had conducted due diligence during the IPO process. Defendants maintained from this that Tronox would have been able to (1) support its environmental, tort and pension liabilities, (2) pay-off approximately $413 million of its debt, (3) refinance all of its debt, and or (4) sell its land and its Uerdingen plant to raise additional cash. The Court found otherwise, however, concluding that the third party projections were overly optimistic, that hypothetical land sales could not make up for the shortfall, and that the ability of a debtor to raise cash by selling off assets was not supportable as an indication of capital adequacy. Additionally, the Court found that Defendants' expert's testimony regarding market evidence confirmed rather than refuted that Tronox was undercapitalized considering facts that Tronox was precluded by its legacy liabilities from raising additional capital, merging with another firm, entering into a joint venture, or attracting private equity.

The ability to pay test under the Oklahoma UFTA examines whether a debtor "intended to incur, or believed or reasonably should have believed that he would incur, debts beyond his ability to pay as they became due." Accordingly, Plaintiffs' expert testified that Tronox would have been unable to pay its debts from

2007- 2012, and by year-end 2012 would have had a cash deficit of $475 million. Noting that the emphasis of the ability to pay test is more short-term, the Court found that the record did not show Tronox was unable to pay its debts as they matured in the short-run, post-IPO. However, the Court did find that Defendants should reasonably have believed that Tronox would incur debts exceeding its ability to pay, noting that Defendants failed to conduct an analysis of Tronox's ability to pay the legacy liabilities.

For purposes of measuring damages, Plaintiffs' expert opined that the fair market value of the E&P assets transferred out was $6.6 billion in 2002 using the Guideline Publicly Traded Company method, and assuming a rate of appreciation from energy indices, brought that amount forward to $12.5 billion as of the date of the IPO in November 2005. Applying a control premium of 30 percent derived from oil and gas transactions increased the value to $15.9 billion, which he corroborated with the $15.8 billion paid by Anadarko to acquire New Kerr-McGee shortly after the spin-off. From this the Court concluded that Plaintiffs had established the value of the E&P assets as of the date of the IPO, and noting that Defendants' expert did not provide an opinion regarding the value of the E&P assets, rejected his criticisms of the control premium and method used by Plaintiffs' expert to calculate the present value of the E&P assets in 2005.

As for the value of other property transferred, the Court observed that Tronox transferred out a total of $1.064 billion, comprised of cash, an interest in a battery company, and the assumption of unfunded OPEB obligations. In return, Tronox received approximately $2.555 billion in transfers from other parts of Kerr-McGee to Old Kerr-McGee, New Kerr-McGee's assumption of debt, the face value of a maximum environmental reimbursement, pre-paid insurance policies and environmental indemnities. Based on these findings, the Court concluded that the net value of the property transferred out was $14.459 billion, and while deferring final judgment, that Tronox would be liable for damages of from $5.1 billion to $14.1 billion depending on the value of Defendants' § 502(h) offset claim.

On April 3, 2014, in what was heralded by the Anadarko Litigation Trust as a "historic settlement," and by the U.S. Department of Justice as "the largest environmental enforcement payment in history," Anadarko Petroleum Corp. agreed to pay creditors $5.15 billion to settle the litigation. On the same day, with the uncertainty regarding the outcome of the litigation resolved, the market value of Anadarko's shares increased by approximately $5.3 billion.

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Details and registration at See https://www.aira.org/

Restructuring the For-Profit Education Sector: Entering A New Era

Joseph R. D'Angelo
Carl Marks Advisory Group LLC

As with other regulated industries, the for-profit education sector has unique issues, which raise constraints when considering restructuring options. The following provides a background on how the industry reached its current state, identifies operating challenges, explains potential restructuring issues, and offers practical solutions.

Overview

The for-profit education industry started with "mom and pop" operators of local and regional schools providing certification programs in vocational trades and some diplomas. As Title IV financial aid grew as a source of revenue, professional managers and private equity sponsors became attracted to the industry. Today, many schools are owned by private equity firms, and the industry expanded both campus-based and online programs to provide bachelor, master, and doctorate degrees.

Public awareness of for-profit schools increased due to professional marketing, the proliferation of campuses, the prevalence of advertising in mainstream and online media, and student experiences of friends and relatives. Recent scrutiny by regulatory agencies and the media about questionable recruiting practices and jobless graduates with credit-ruining debt also raised public awareness and concerns about the industry.

From 2000 to 2010, industry revenue grew at a Compound Annual Growth Rate (CAGR) of 17.5%, from \$5.9 billion to \$29.6 billion.[1] The sector grew by offering a post-secondary education to students for whom tradtional schools were not well-suited. Institutions grew quickly by building new campuses and adding programs both locally and online that were eligible for federal financial aid in the form of Title IV funds. Associate and bachelor degrees drove most of the growth in enrollments and revenue. Increased course offerings and evening sessions also provided flexibility for students from a broader demographic to pursue degrees.

Through 2010, there were 74 mergers and acquisitions totaling \$11.8 billion.[2] Revenue growth and high-profit margins drove a large number of public and private transactions. Most for-profit schools with critical mass are either publicly owned or held by private equity firms. There are fifteen publicly traded schools that report financial and operating information to the SEC. Public valuations of for-profit education operators are under pressure due to decreased enrollments, poor outlook visibility, increasing regulations, and significant litigation risk. As of January 2014, fourteen (out of 15) publicly-traded, for-profit education enterprises had an average trailing twelve months EBITDA multiple of 5.0 (see Exhibit 1).

Most investors in for-profit schools are attracted to the revenue provided by the federal government as Title IV financial aid. Over 80% of the revenue at for-profit schools comes from federal aid programs; the balance comes from state and work agency grants, family support and private loans.[3] For-profit schools participating in Title IV programs are required to be accredited by recognized national or regional agencies. The Department of Education ("ED") administers the Title IV program and disburses funds directly to schools to cover tuition, books, fees and living expenses. Title IV federal loan programs include Stafford, Perkins and PLUS loans requiring the student to carry the debt and repayment obligation.

Exhibit 1: For-Profit Education Valuations TTM EBITDA

Company	Ticker	Price	EBTIDA ($ MM)	Secured Debt	Total Debt	Debt/ EBITDA	Mkt. Cap ($ MM)	EV ($ MM)	EPS	Forward P/E	EV/ TTM EBITDA
American Public Education, Inc.	APEI	$39.56	$83.8	$0.0	$0.0	-	$696.5	$575.9	$2.5	14.7	6.9
Apollo Group Inc.	APOL	18.40	758.0	52.3	87.6	0.1	2,076.2	1,273.9	2.7	9.2	1.7
Bridgepoint Education, Inc.	BPI	16.28	213.7	-	-	-	880.9	452.4	2.3	20.2	2.1
Capella Education Co.	CPLA	47.93	67.0	-	-	-	594.0	449.2	2.6	17.1	6.7
Career Education Corp.	CECO	3.84	(22.8)	0.1	0.1	(0.0)	257.5	(30.2)	(3.2)	NM	NM
Corinthian Colleges Inc.	COCO	2.38	116.4	20.7	30.7	0.3	205.1	191.9	(0.1)	12.5	1.6
DeVry, Inc.	DV	30.78	333.6	-	-	-	1,935.7	1,663.7	2.3	12.7	5.0
Education Management Corporation	EDMC	7.10	386.7	1,088.5	1,319.1	3.4	884.7	2,020.2	(11.7)	24.4	5.2
Grand Canyon Education, Inc.	LOPE	35.76	146.3	100.4	99.0	0.7	1,626.8	1,574.2	1.7	19.5	10.8
ITT Educational Services Inc.	ESI	27.82	310.5	150.0	150.0	0.5	649.9	589.9	4.7	8.4	1.9
Lincoln Educational Services Corporation	LINC	6.76	24.0	35.9	35.9	1.5	162.3	180.9	(1.9)	219.4	7.5
National American University Holdings, Inc.	NAUH	3.90	15.7	10.5	10.5	0.7	97.7	74.9	0.2	13.7	4.8
Strayer Education Inc.	STRA	50.55	127.0	124.2	125.2	1.0	520.2	594.6	5.3	13.3	4.7
Universal Technical Institute, Inc.	UTI	11.65	27.0	-	-	-	284.4	205.1	0.2	65.0	7.6
	Mean	**$21.62**	**$184.8**	**$113.0**	**$132.7**	**0.6**	**$776.5**	**$701.2**	**$0.6**	**34.6**	**5.1**
	Median	**$17.34**	**$121.7**	**$15.6**	**$20.6**	**0.2**	**$622.0**	**$514.2**	**$2.0**	**14.7**	**5.0**

Note: Data as of 1/6/2014.

1 National Center for Education Statistics (NCES) – Integrated Postsecondary Education Data System (IPEDS).

2 Public Company Equity Research.

3 National Center for Education Statistics (see fn. 1).

Exhibit 2: Title IV Revenues for 2008-2012 (in $Billions)

Ownership Type	2007-2008	2008-2009	2009-2010	2010-2011	2011-2012
Publicly Traded	$8.9	$15.4	$20.4	$21.4	$17.8
Privately Held	7.7	8.5	11.6	12.6	11.8
For-Profit School Totals	16.6	23.9	32.0	34.0	29.6
All Postsecondary Schools Total	$85.8	$105.7	$133.1	$145.7	$144.0
For-Profit School Share of Total	19%	23%	24%	23%	21%

US Department of Education Federal Student Aid

Title IV disbursements grew at a 10% CAGR from 2000 to 2010, while for-profit revenue grew at 18% CAGR.[4] In 2010, for-profit schools received $32 billion in financial aid averaging $6,997 per student.[5] For-profit schools absorbed a portion of the increase in federal aid by targeting the most eligible students, usually of lower-income means. From 2007-2012, total post secondary Title IV applications and awards increased almost 68%, from $85.8 billion to $144 billion (see Exhibit 2 above).

From 2000-2012, student enrollment in for-profit schools grew at a CAGR of approximately 16%. During this same time period, total post-secondary enrollment grew at a CAGR of less than 2%. For-profit schools increased their market share of total student enrollments from less than 3% in 2000 to 9.6% in 2010.[6]

The growth attributable to Title IV financial aid is highlighted in the revenue breakdown between 2007 and 2009 for University of Phoenix (APOL), Corinthian Colleges (COCO), and ITT Technical Institute (ESI), as shown in the table below. The incremental Title IV funds year-over-year account for more than 100% of total revenue growth, replacing declines in non-Title IV revenue in the same period.[7]

After consolidation and rapid growth, for-profit schools faced increased regulatory scrutiny as Congress learned that in 2012 for-profit schools enrolled approximately 11% of the post-secondary students in the country, received 25% of the financial aid awarded, and represented 47% of the loan defaults.[8]

For-Profit Ed Revenue Growth

	2007	2008	2009
Apollo Group (APOL)			
Total Revenues	2,724	3,141	3,974
% YoY Growth		15%	27%
Title IV Revenues	1,770	2419	3537
%YoY Growth		37%	46%
% Revenue Grown from Title IV		**156%**	**134%**
Corinthian Colleges (COCO)			
Total Revenues	919	1,069	1,308
% YoY Growth		16%	22%
Title IV Revenues	691	866	1,163
%YoY Growth		25%	34%
% Revenue Grown from Title IV		**117%**	**124%**
ITT Technical Institute (ESI)			
Total Revenues	758	870	1,015
% YoY Growth		15%	17%
Title IV Revenues	477	635	863
%YoY Growth		33%	36%
% Revenue Grown from Title IV		**141%**	**157%**

4 The Parthenon Group.

5 Ibid.

6 Ibid.

7 Ibid.

8 Ibid.

For-Profit Education Market

The for-profit education sector grew by offering a post-secondary education to students not suited for traditional schools. Much of the increased demand for post-secondary education is from non-traditional students who delayed college, are largely independent, older, and often work part or full-time while pursuing a diploma or degree. Non-profit schools (community colleges and traditional public and private colleges and universities) lack the flexibility and structure to address the needs of non-traditional students. Accordingly, for-profit schools account for 65% of students 25 years of age or older.[9]

Non-traditional students lacking parental support are typically heavier users of Title IV financial aid versus traditional students that usually receive financial support from their parents. For-profit schools competitively target non-traditional students by:

- Aggressive recruiting and heavy advertising
- Providing guidance to low income students on federal loan applications
- Developing highly focused, career-oriented programs
- Offering classes at multiple locations at convenient times as well as online.

However, the protracted economic recovery negatively impacted campus enrollments, because potential students are skeptical of the availability of higher paying jobs and want to avoid taking on the student debt (See Exhibit 3). Some for-profit schools are consciously slowing their own growth in order to focus on student outcomes and comply with new industry regulations. Schools are implementing higher admission standards and moving away from open enrollments to become more selective and increase retention, graduation, and placements rates. In the short term, schools are expected to adapt to lower student populations and higher mix of online students.

Exhibit 3: Total For-Profit Student Populations [10,11]

Ticker	FYE 2008	FYE 2009	FYE 2010	FYE 2011	FYE 2012
APEI	45,000	63,700	83,700	110,000	127,000
APOL *	362,100	443,000	470,800	380,800	328,400
BPI	31,558	53,688	77,892	86,642	81,810
CECO	98,000	105,300	116,800	98,000	76,000
COCO	64,928	80,939	105,494	90,507	91,460
CPLA	26,883	33,982	39,477	37,704	36,329
DV *	76,208	101,342	124,043	131,116	128,788
EDMC *	95,900	110,800	136,000	158,300	151,200
ESI	61,983	80,766	84,686	73,255	61,059
LOPE	24,636	37,709	41,482	43,917	52,292
STRA	44,564	54,317	60,711	54,233	51,727
Total	**931,760**	**1,165,543**	**1,341,085**	**1,264,474**	**1,186,065**

* Fiscal year end other than December 31.

9 Public Company SEC 10Q, 10K and 8k filings.

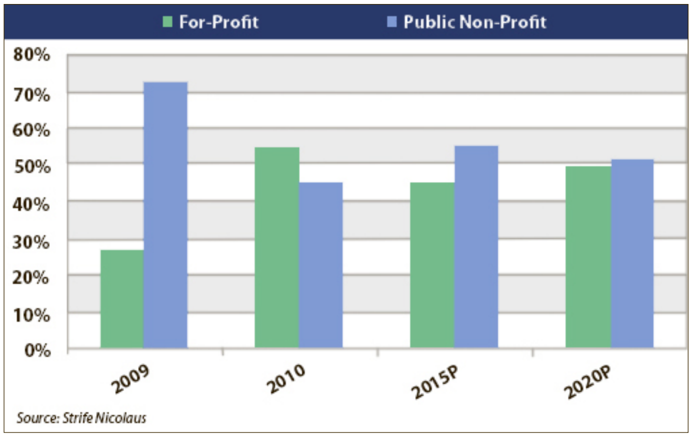
For-profit schools have been quick to develop and offer online programs that provide greater flexibility at a lower price point. Consequently, the majority of new student enrollments are in online programs. For-profit schools operating ground campuses continue to see quarterly declines in enrollments and are pressed to rationalize unprofitable campuses and programs.

Growth in Online Students

Since 2000, total online enrollment grew at a 31% CAGR to almost 2.5 million students in 2010. The growth rate is currently decreasing, but remains above traditional enrollments. By 2015, online enrollments are expected to grow to almost 3.5 million students. (see Exhibit 4) For-profit schools' market share of online enrollments is split roughly 50/50 with non-profit schools.[12] It is important to note though that within the for-profit sector, online enrollment, including both online-only and the combination of online / ground school, is estimated to account for 58% of total sector enrollment.[13]

Although online enrollments continue to increase, current studies show that most students do not complete the program or pass the final exam. Increasing regulation is putting pressure on for-profit schools to ensure that online diplomas and degrees lead to job placements and gainful employment.

Exhibit 4: For-Profit v. Non-Profit Online Market Share



Working Capital and Liquidity

EBITDA margins declined from approximately 25% in 2010 to 18% in 2012.[14,15] Increasing regulation, declining enrollments, lower absorption of fixed costs, and decreasing advertising and lead conversion rates contributed to lower profitability. Pressure on EBITDA margins is expected to continue due to competitive pricing of tuitions, new regulations focused on student outcomes, and the related spending on student placement resources. All of these conditions negatively impacted working capital and liquidity.

Cost of Acquiring New Students

Since 2002, historical selling and marketing expenses for select publicly traded for-profit schools averaged between 20% and 25%.[16] During 2008-2010, total spending on selling and marketing increased from $2.7 billion to $3.6 billion, but dropped as a percentage of revenue from 25.1% to 22.3% due to disproportionate revenue growth.[17] From 2010 to 2012, aggregate marketing dollars stayed relatively flat between $3.6-$3.8 billion per year, but increased to over 25% of revenue due to lower revenue from declining enrollments, fewer leads, and lower conversion.[18]

Selling and marketing expenses typically include advertising, leads, recruiting, and admissions costs. It is difficult to calculate a standard cost of acquiring new students because companies do not report the expense categories consistently.[19] Using publicly reported information, the cost of acquiring a new student ranges from $1,800 to $4,000.[20] With such a high acquisition cost, for-profit schools feel the need to offer longer programs and degrees with higher tuition in order to increase the payback. However in many cases, for-profit schools' tuition costs for associate and bachelor degrees are higher than non-profit alternatives at community colleges and state universities. In addition, a large part of the market of prospective students wants *shorter and cheaper* programs that minimize debt and lead to better employment sooner.

Changes in Regulatory Environment

Beginning in 2009, for-profit schools suddenly faced increased regulatory scrutiny as Congress learned that for-profit schools accounted for a disproportionate share of defaults under the Title IV program. The U.S. Senate Committee on Health, Education, Labor and Pensions ("HELP" Committee) has oversight responsibility for the for-profit education sector. In April 2010, Chairman Tom Harkin initiated an investigation to better understand the enormous growth in both the number of students attending for-profit schools and the federal student aid investment that taxpayers are making in the schools. In July 2012, the HELP Committee issued its report titled "For Profit Higher Education: The Failure to Safeguard the Federal Investment and Ensure Student Success."[21]

Summary of Key Findings: [22]

- In 2008-2009, for-profit colleges enrolled between 10%–13% of total students (over 2.2 million students), received 25% of all federal financial aid awarded, and represented 47% of all federal student loan defaults.
- More than 1 in 5 students enrolling in a for-profit school (22%) defaults within 3 years of entering repayment on their student loans.
- On average, for-profit schools spend 25% of revenue on advertising and recruiting, 17% of revenue on educating students and earn 19% in profits.
- The HELP Committee recommended enacting regulations that focus on student outcomes including retention, graduation, job placement and repayment rates.

[10] Public Company Equity Research.

[11] United States Department of Education Office of the Inspector General July 23, 2013 Report - "Transparency of Proprietary Schools' Financial Statement Data for Federal Student Aid Programmatic Decision making".

[12] Public Company Equity Research.

[13] Ibid.

[14] Ibid.

[15] See Footnote 11.

[16] Public Company Equity Research.

[17] Ibid.

[18] Ibid.

[19] United States Department of Education Office of the Inspector General July 23, 2013 Report - "Transparency of Proprietary Schools' Financial Statement Data for Federal Student Aid Programmatic Decision making".

[20] Ibid.

[21] United States Senate Health, Education, Labor and Pensions Committee (HELP) July 2012 Report – "For Profit Higher Education: The Failure to Safeguard the Federal Investment and Ensure Student Success."

[22] National Center for Education Statistics (NCES) – Integrated Postsecondary Education Data System (IPEDS).

Since the release of the HELP committee report and other critical studies, a public debate ensued among politicians, academics, school operators, regulators, and accreditors on the efficacy of for-profit schools and a shift toward measuring student outcomes. In addition, the White House has taken a stern approach to holding for-profit schools accountable for the Title IV funds received for students. As a result, new regulation and changes to existing regulations were implemented and proposed.

In 2009, ED revised the 'safe harbor' rules for incentive compensation regulations essentially to forbid Title IV schools from providing any commission, bonus, or incentive payment to recruiters based solely on enrollments. Some schools are defendants in whistleblower lawsuits brought by former employees alleging violations in recruiting practices and performance compensation plans. Now, schools use outside professionals to help structure and draft compensation plans to maintain compliance and demonstrate objectivity.

Since 2010, other regulations were introduced that reduced the addressable market and funds available under certain programs like PELL. Students without high school diplomas had formerly been allowed access to Title IV under the Ability to Benefit ("ATB") guidelines. ATB students enrolled in vocational programs to improve their job skills. The Department of Education ended the ATB program abruptly in 2011. Many for-profit schools created offerings to appeal to ATB students and struggled to replace the loss of ATB students. ATB students represented upwards of 20% of the student population at some schools. Contraction in student enrollments started with the need to replace ATB students.

Currently, for-profit schools collecting Title IV funds maintain eligibility by complying with the following laws and regulations:

- Composite Score – Part of the Financial Responsibility Standards under the Higher Education Act to measure a school's financial health. Schools carrying debt are penalized in the calculation.
- 90/10 Rule – For-profit schools must receive less than 90% of total revenue from Title IV funds. Schools that receive more than 90% of revenues from Title IV funds in any two consecutive fiscal years will cease to be eligible to participate in Title IV programs.
- Cohort Default Rates ("CDRs") – Schools with a greater than 30% default rate for three consecutive years, or 40% in any one year, lose Title IV eligibility. This rule was originally measured for the first two years after graduation using a lower threshold.
- Gainful Employment – Measures the performance of placing students into jobs with wages adequate to repay their debt. The current proposed measures below are being considered in the Proposed Rulemaking Process and would not be implemented until 2015. Nonetheless, schools are using the measures to assess the potential impact on non-compliant programs.

A three-part test is being proposed:

1. Debt-to-Income Ratio – the ratio of monthly debt payments to monthly income must be less than 12%.
2. Debt-to-Discretionary Income Ratio – the ratio of monthly payments to monthly 'discretionary' earnings must be less than 30%.

A school is deemed non-compliant if it fails both debt measures in two of three years or if a school fails either debt measure in four consecutive years.

3. Program Cohort Default Rate ("CDR") – the percentage of students defaulting on federal loans within three years of graduation must be less than 30%

A school is deemed non-compliant if it fails the CDR in three consecutive years.

ED estimated that roughly 14% of existing programs at for-profit schools would likely fail under the proposed measures,[23] and BMO Capital Markets estimated upwards of 1,400 programs or 20% would fail.[24]

In addition to federal and state regulations, for-profit schools are dealing with inquiries and lawsuits from the SEC, the Consumer Financial Protection Bureau (CFPB), Office of Inspector General (OIG), accreditors, and the Department of Justice and States Attorney General.

Investors and lenders are rightly concerned about the significant regulatory and litigation risks in the sector.

Commentary on the Restructuring Issues

Many for-profit schools acquired by private equity firms took on term debt to finance the acquisition. In addition, schools typically require a revolver for the following purposes:

- To fund working capital needs during seasonal periods of lower student enrollments and timing of Title IV disbursements
- To draw down at fiscal year-end to improve the Composite Score calculation
- To fund necessary Letters of Credit in favor of ED and state agencies related to Title IV and grants
- To manage 90/10 Rule compliance and the ratio of Title IV to non-Title IV revenues

For-profit schools operating with leverage face tightening liquidity and could require restructurings or asset sales. However, it is difficult to de-lever given the low valuation multiples compared to leverage ratios. Schools carrying debt could be struggling with fixed charge and leverage covenants as year-over-year EBITDA decreases. Credit agreements also typically include covenants for regulatory compliance, which could be tripped for the Composite Score or the 90/10 Rule. Liquidity at some schools is so dire, payment defaults may occur.

School owners, operators, and lenders generally focus on the following primary issues:

- Restructuring in Bankruptcy is not an option in this sector. Access to Title IV funds and accreditation are both forfeited under a Chapter 11 filing.
- For a lender, declaring a loan default jeopardizes Title IV eligibility and should be dealt with in an alternative way if possible (amendment, waiver, forbearance, standstill, etc.).
- Declaring a loan default also jeopardizes accreditations which are required for Title IV eligibility.
- Acquisitive companies booked significant goodwill and now face the risk of impairments which will reduce a school's Composite Score.
- A Composite Score violation could trigger a liquidity event if ED requires the school to post Letters of Credit.

23 National Center for Education Statistics (NCES) – Integrated Postsecondary Education Data System (IPEDS).

24 Public Company Equity Research.

- Campuses and program offerings are continually rationalized to maintain profitability.
- When a school shuts down, it is required to conduct a "Teach Out" plan to complete the instruction of its current students which typically uses up the remaining assets and suppresses liquidation recoveries.
- Capital Expenditures for growth and maintenance are limited due to tight liquidity, constraining the ability to remain competitive by developing new programs and refurbishing facilities.
- Acquisitions make a quicker impact to maintain compliance with the 90/10 Rule and CDRs.
- Some schools struggle with systems integration issues from acquired schools. Information systems and technology is a critical competency in this space.
- The SEC is investigating the use of private student loan programs which for-profit schools rely on for student gap financing that counts toward the "10 Money" (Revenue that counts toward the 10 in the 90/10 Rule).
- ED can be abrupt in its non-compliance notices, but slow to respond to counterarguments and appeals.
- Increasing regulations put downward pressure on enrollments and revenues because schools will have to cancel failing programs and be more selective in admissions to improve student outcomes.

Observations and Recommendations

Student enrollments may continue decreasing on a quarterly year-over-year basis as schools adjust to the demand of a more normal student population (See Exhibit 5 below).

Schools reliant on Title IV typically acquire other schools to add non-Title IV revenue or help improve regulatory compliance. Accredited schools with non-Title IV revenue, a good footprint, and a solid reputation are in demand. Consolidation may be a normal expectation, but the market conditions don't support it.

Private owners would like to sell but EBITDA may be down and valuation multiples are low. Strategic acquirers meanwhile are rationalizing their holdings to the new environment and are also less acquisitive due to challenges in accessing the capital markets and the increasing cost of capital for this sector. Acquirers new to the industry are throttled by the need to get approved by ED and accrediting agencies for a change of ownership.

Distressed investors are interested in the sector; however, over leveraged schools struggling on multiple fronts are still not trading at distressed levels, offering few opportunities for now. Increasing lender fatigue, concerns about the risk of association with schools in legal trouble, and the lack of refinancing exits may influence lenders to eventually sell their commitments to distressed investors. Students, investors, and lenders would be better served if for-profit school operators focused on refining their product and improving their core processes. Critical success factors for thriving schools will include:

- Price competitive programs with higher touch and a better experience to increase retention and outcomes
- Optimization of digital marketing, advertising, and recruiting to increase conversion and decrease cost of acquisition
- Improvements in cash management by linking organizational business processes between the financial aid and the finance groups
- Vigilance in using an Internal Audit function to enforce and maintain regulatory compliance and to create a constant readiness for regulatory reviews and renewals
- A market management approach that seeks to expand in successful existing markets before launching in new markets

Ultimately, for-profit schools need to provide an education product that is valued by employers. For-profit schools need to improve their product by continuing to focus on effective programs in strong job markets, but also by revisiting all aspects that touch the consumer. For example, some schools are revising their pricing and value proposition by lowering tuitions; some are offering scholarships which are effectively discounts; and others are using athletic teams and a traditional campus theme to increase student affinity with the school.

Campus-based programs are being revamped to include an online component that provides flexibility for the student to not have to come to the campus on Fridays. Conversely, online students

Exhibit 5: Quarterly Year-Over-Year Results for Selected For-Profit Providers[25]

Companies	Qtr. Revenue	Qtr. Revenue YoY% Δ	Qtr. EBITDA	Qtr. EBITDA YoY% Δ	Qtr. Population	Qtr. Population YoY% Δ	Qtr. Starts	Qtr. Starts - YoY% Δ	Qtr. Revenue/ Student	Qtr. EBITDA/ Student
American Public Education, Inc.	$ 81.8	6.0%	$ 20.9	3.2%	105,200	2.1%	22,100	-7.9%	777	199
Apollo Group Inc.	845.0	-15.2%	138.8	-3.4%	269,000	-18.1%	41,000	-22.3%	3,141	516
Bridgepoint Education, Inc.	185.6	-26.4%	21.6	-60.7%	68,566	-24.9%	12,500	-39.0%	2,707	315
Capella Education Co.	100.7	1.4%	16.6	6.4%	34,503	-1.4%	N/A	N/A	2,919	481
Career Education Corp.	251.3	-20.5%	(40.0)	-84.6%	56,300	-22.3%	15,470	-18.0%	4,464	(711)
Corinthian Colleges Inc.	365.0	-9.2%	10.6	-71.1%	80,032	-11.5%	28,551	-8.1%	4,560	132
DeVry, Inc.	450.9	-6.6%	41.2	-40.0%	124,085	-4.8%	N/A	N/A	3,634	332
Education Management Corporation	580.4	-4.8%	50.5	-6.1%	117,720	-8.5%	30,770	-6.1%	4,930	429
Grand Canyon Education, Inc.	152.4	14.1%	45.1	22.6%	59,914	14.7%	N/A	N/A	2,544	753
ITT Educational Services Inc.	259.4	-17.6%	38.3	-50.7%	60,997	-7.1%	20,307	5.2%	4,253	628
Lincoln Educational Services Corporation	88.5	-13.3%	1.2	-85.5%	16,105	-14.5%	6,523	-5.2%	5,495	72
National American University Holdings, Inc.	30.9	4.7%	1.1	-15.4%	10,743	3.8%	N/A	N/A	2,879	105
Strayer Education Inc.	110.0	-11.5%	12.7	-8.6%	43,192	-16.5%	N/A	-23.0%	2,547	294
Universal Technical Institute, Inc.	91.0	-8.7%	6.4	-15.3%	13,800	-9.8%	2,500	-7.4%	6,591	465

[25] United States Department of Education Office of the Inspector General July 23, 2013 Report -"Transparency of Proprietary Schools Financial Statement Data for Federal Student Aid Programmatic Decision making,"

may have a day on campus for a class, tutoring, group projects or labs. Schools are increasingly using technology to track students' progress and be able to intercede when student persistence is at risk. Strategies and approaches that help increase retention will directly increase profits.

For-profit education is a direct marketing business, and schools spend a lot of money on advertising and recruiting. Typically, there are opportunities to increase the cost efficiency of this operation by using third-party digital marketing firms to improve the quality of Internet leads, which increases conversion; optimizing the media buying function to get the right spots and day parts; and balancing the cost of internal call centers and outsourced capacity.

With liquidity continuing to tighten, school operators should implement a cash forecasting process that is linked between the finance group and the financial aid processing group, since the majority of collections come from ED. Schools usually use a revolver to fund quarterly working capital needs and at fiscal year-end for 90/10 management and the Composite Score. The revolver is also typically structured to include capacity for posting letters of credit to ED and state agencies as recourse protection in case funds were disbursed that later need to be clawed back for noncompliance or other reasons. Most schools with debt do not have enough free cash flow to get through the year without using the revolver for working capital. Interest costs can be reduced and revolver availability can be conserved by using a 13-week cash forecast. The receipts section of the forecast should be provided by the financial aid group which manages the processing and disbursement of Title IV funds from ED. The finance group should work closely with the financial aid group to ensure processing resources are optimized. For example, it is cheaper to make the joint decision to pay overtime in the financial aid group to get loan batches processed than it is to draw on the revolver.

Many corporations use an internal audit group to take a disciplined and objective approach in risk management and controls. In for-profit education, internal audit groups can help ensure that business processes are systematically compliant with regulations and that data provided to ED and accreditors is accurate, complete, and timely. Schools spend significant resources on managing issues related to noncompliance. ED, accreditors, state agencies, the SEC, CFPB, OIG, and other regulators can all file subpoenas, information requests, Show Cause actions, and lawsuits at any time for noncompliance and business practices. Most schools think this is a cost of doing business and manage a docket of ongoing issues all toward ultimately settling without admitting wrongdoing. Other industries successfully use an internal audit group to minimize these types of risks and costs.

Expanding into new markets could cost upwards of $2.5 million in improvements and take up to two years to break even. In addition, property leases are usually signed for ten-year commitments with equal renewal options, and rent is the highest fixed cost for a school campus. Unprofitable campuses that are not able to absorb the facility costs would be shut down and taught out, but the ongoing lease commitment and cost prevent operators from grooming their existing markets. School operators should try to expand within existing successful markets before expanding into new markets because the payback is shorter, the marginal impact is greater, and the execution risk is lower. Schools can also increase cost absorption and profitability by adding programs at existing campuses that better balance students and resources. For example, campuses with surgical labs for surgical technician programs can offer sterilization and other programs that use similar training environments. Adding trade programs, such as commercial driving, HVAC, and auto tech to attract male students, which diversifies the demographic of the student population.

Ultimately, the for-profit education sector will continue to mature and evolve with the market, and the regulatory environment will be increasingly onerous on school operators. However, investors understand that for-profit schools fulfill a market need and that there is money to be made. The sector could benefit by working together to develop an image campaign – other than TV advertising to attract students, the sector does not do much to build a positive public image. Projected labor statistics and job studies suggest there will be a shortage of skilled workers, and the for-profit education sector is better positioned to address this shortfall than traditional schools. Inevitably, for-profit schools will have to restructure their operations to increase profitability and future growth. Similar to healthcare, food and other consumables, consumerism is increasingly driving students' decisions. For-profit education winners and losers will likely be defined by quality and price.

For a Self Study course on this topic based on a recent webinar with author Joseph D'Angelo and others, see www.AIRA.org

Joseph R. D'Angelo *is a partner at Carl Marks Advisory Group and has more than 20 years of experience in operating and advisory roles, improving underperforming businesses and advising debtors and lenders in complex restructuring matters. He has served as Chief Restructuring Officer, Chief Executive Officer, Chief Operating Officer, Chief Financial Officer, and Advisor in middle-market companies and large enterprises. His industry experience includes automotive, manufacturing, entertainment, print and digital media, for-profit education, software, specialty finance, staffing and telecommunications (wireline, cable, broadband, wireless and satellite.*

MEMBERS IN THE NEWS

Soneet Kapila, CIRA, and Barry Mukamal Form New Firm—KapilaMukamal, LLP

Soneet Kapila, CIRA, and Barry Mukamal have announced the formation of a new consulting firm named KapilaMukamal, LLP, effective May 1, 2014, with offices in downtown Miami and Fort Lauderdale. KapilaMukamal, LLP will provide fiduciary and insolvency services including restructuring, forensic and investigative consulting and litigation support services as well as business valuations and matrimonial forensics. For more information, visit www.KapilaMukamal.com.

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Keynote Speakers

Governor John Hickenlooper, State of Colorado (invited)
John Hickenlooper, a self-described "recovering geologist now on loan to public service," was elected Governor of Colorado in 2010. His unconventional road to the Capitol began when he left the oilfields of western Colorado in the late 1980s and opened the state's first brewpub. John's business grew, helping to revitalize a now popular neighborhood in downtown Denver, and he became active in Denver's civic life. One thing led to another, until, goaded by friends and other business leaders, he successfully ran for Mayor of Denver in 2003. John had served nearly eight years as mayor when he was encouraged to make a run and quickly garnered support to be the Democratic candidate for Governor. John won 51 percent of the vote in a three-way race. He earned a bachelor's degree in English and a master's degree in geology, both from Wesleyan University, and moved to Colorado in 1981.

Diane Barrett, Chief Projects Officer, City & County of Denver
A lawyer for nearly twenty-five years, Diane Barrett practiced primarily in the areas of public finance and land use/development. Her practice emphasized financing public infrastructure for local governments and for private development projects. She was appointed Special Assistant for Transportation and Development by Mayor Hickenlooper in 2005, after retiring from the active practice of law and she was appointed Chief Projects Officer by Mayor Hancock in 2011. Ms. Barrett's primary responsibility for Mayor Hickenlooper was to oversee the redevelopment of the Denver Union Station site into a multi-modal hub for Fastracks. In the Vidal administration and now in the Hancock administration her responsibilities have expanded. Her current portfolio comprises all development and redevelopment projects in Denver, including the region-wide FasTracks project and all related transit-oriented development.

Tom Binnings, Senior Partner, Summit Economics
After working in the field of applied economics for 33 years, Mr. Binnings formed Summit Economics with four leading economists. As a researcher, he authored numerous studies on a wide range of topics in a number of industries. His work began with community, urban and regional economics and has expanded to include real estate and organizational economic analysis for strategic and tactical planning as well as process improvement. Mr. Binnings has facilitated discussions with and presented before boards, commissions, councils, citizen groups, and the state legislature.

Preconference Program

8:30 am – 5:15 pm

Concurrent Seminar 1
Bankruptcy Taxation

Concurrent Seminar 2
Financial Advisors' Toolbox

Concurrent Seminar 3
Financial Modeling

Morning Session - Introduction to Excel and Three Statement Forecasting

Afternoon Session - 13 Week Cash Flow Modeling

12:00 – 1:45 pm

Lunch and Keynote Presentation by:
Diane Barrett, *Chief Projects Officer, City and County of Denver*

6:30 – 8:00 pm

AIRA's 30th Annual Conference Opening Reception

Sponsored by: **Conway MacKenzie, Inc.**
Duane Morris LLP

Fly Casting Clinic - Thursday, 12:15 pm

Fundamentally, fly fishing is the art of mimicking nature and fly casting. Join a two-part fly fishing program - first, an indoor fly fishing overview where you'll learn about habitat, entomology, equipment and terminology. Next, you'll go to City Park for a fly fishing casting clinic where you'll be provided with a fly rod and professional instructors to learn basic fly casting techniques.The indoor overview is open to all conference participants.

Price $100, *including a boxed lunch for those participating in the outdoor casting clinic.*

Golf at Fossil Trace - Thursday, 12:30 pm

Fossil Trace Golf Club is one of Denver's premier public golf courses designed by renowned golf course architect Jim Engh. Located in Golden, Fossil Trace is nestled adjacent to the foothills of the Rocky Mountain Front Range. The golf course opened in 2003, approximately 64-million years after the first dinosaurs walked where holes 11-15 now sit. Triceratops footprints and other prehistoric creatures' fossils can be viewed adjacent to the 12th green.

Golf *Sponsored by* Deloitte; **Drink Cart** *Sponsored by* Burr & Forman

Price $120.

Denver Microbrew Tour & Tasting - Thursday, 1:30 pm

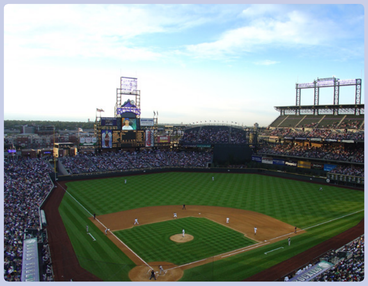
With more microbreweries than any other state in the country, Colorado is a beer drinker's delight! Known as the "Napa Valley of beer," you'll visit microbreweries and a tap room in downtown Denver where you'll get the opportunity to see the unique malting and brewing process and enjoy beer samples. You'll also learn interesting beer trivia. And who knows, maybe you'll discover a new favorite brew!

Price: $50.

Tour of Molly Brown House & Tea - Thursday, 1:30 pm

Historic Denver's Molly Brown House Museum is among the most visited historic sites in the state of Colorado, and one of only a handful of sites nationally dedicated to the interpretation of a woman's story. Open for more than 43 years, the Museum serves nearly 50,000 people every year, including 10,000 youth. Enjoy a tour of the Museum, followed by a traditional High Tea.

Price $50.



MLB Baseball Outing: Rockies v. Dodgers - Friday, 6:00 pm

Pregame Reception 6:00 pm—Game Start 6:40 pm

Start the summer off right with an evening at Coors Field to witness a battle between National League West rivals, the Colorado Rockies and the Los Angeles Dodgers! Mezzanine Party Suite 60 A & B is reserved for AIRA's group—food, soft drinks and balcony seats included.

Price $120. *Tickets may be purchased online, or at the onsite Conference Desk.*

Conference Sponsors

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The Archaeology of Professional Ethics in Bankruptcy: Part II

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This is Part II of a two-part series on what we can learn from archaeology as bankruptcy practitioners (see AIRA Journal, Volume 28: No. 1, Winter 2014). Specifically, I have drawn from the study of archaeological ethics and virtue theory. I begin this part with a look at common law duties as part of the matrix of rules and standards that regulate conduct. I then build from there a bolder return to the virtues, where a bankruptcy practitioner's character or virtue is primary and her actions are important but secondary.

Some Common Law Duties to Keep in Mind

In addressing ethical duties of a bankruptcy practitioner, it is also important to draw lessons from the general body of law regulating the affairs of fiduciaries. Although a healthy academic debate over the precise definition of fiduciary exists,[1] the following can be used as a general starting point:

> A fiduciary relation[ship] exists between two persons when one of them is under a duty to act for or to give advice for the benefit of another upon matters within the scope of the relation.[2]

A fiduciary or fiduciary party is the person or entity obligated to act for the benefit of another. In the corporate fiduciary relationship, fiduciary parties include all directors, non-director officers, and, in some jurisdictions and in certain circumstances, controlling shareholders. In addition to the typical fiduciaries in the corporate context, in the chapter 11 bankruptcy plan process, the fiduciaries may include the debtor in possession, the trustee or examiner (if one is appointed), and the Official Committees. *A beneficiary or beneficiary party* is the person or entity for whom the fiduciary is obligated to act. Beneficiaries in the corporate fiduciary relationship include all shareholders of the corporation while the corporation is solvent, and, according to emerging authority, creditors of the corporation while the corporation is insolvent or in the vicinity of insolvency. In the chapter 11 plan process, the beneficiaries include the bankruptcy estate and, indirectly, the creditors as a class and, in some instances, the equity holders. A fiduciary and a beneficiary are the parties to a *fiduciary relationship*.

In analyzing any fiduciary relationship, it is helpful to distinguish the *existence* of a fiduciary relationship from the determination of the contours of the fiduciary obligation.[3] Only after it is established that a relationship is, in fact, fiduciary, can it be determined if a breach of a fiduciary obligation has occurred. Often, courts have hesitated in finding the existence of a fiduciary duty where one, in fact, has been clearly established, because the court believed no such duty had been breached. This approach has distorted the development of the law in this area.

Types of Fiduciary Duties

Each fiduciary relationship is made up of constituent *fiduciary duties*. These duties, with some notable limitations, are essentially per se rules to the contract adopted by the corporation and accepted by the shareholder and imposed by bankruptcy law and, in some instances, state model rules of professional conduct. Relevant duties in the corporate fiduciary relationship include the duty of care, the duty of loyalty, the duty of good faith, and the duty of obedience. The combination and requirements of these duties depend on the circumstances of the particular fiduciary relationship. Whatever the amalgamation of these duties, they form a *fiduciary obligation* that regulates certain specific conduct between the *fiduciary* and the *beneficiaries*.[4]

Duty of Care

The duty of care requires that a director exercises the level of care that a person in a like position would exercise under similar circumstances.[5] The duty of care requires that management act in an informed and considered manner. Thus, prior to making a decision, the fiduciary must have reasonably informed themselves of "all material information reasonably available to them."[6] In short, the duty of care requires that a fiduciary act with a reasonable amount of attention and skill.

Duty of Loyalty

The duty of loyalty springs from the concept that the law seeks to prevent material conflicts of interest, particularly in the area of fiduciary relations.[7] A servant can have but one master. Fiduciaries must put aside personal benefit, sacrificing such benefit for the good of the corporation. Fiduciaries must also make full disclosure of potential conflicts of interest and may need to abstain from voting and, in some circumstances, from consideration of such matters. Duty of loyalty cases tend to cluster around management self-aggrandizement, self-dealing, usurpation, or the like.

Duty of Good Faith

The duty of good faith is the cornerstone of the relationship between fiduciaries and the debtor corporation in the chapter 11 plan process.[8] Historically, the duty required honesty in fact. Corporate crime, fraud, theft, misrepresentation, and the like are common examples of breaches of the duty of good faith. Presently, the venerable doctrine is evolving, and courts are insisting in not only honesty in fact, but also reasonable conduct.

1 Compare Austin W. Scott, *The Fiduciary Principle*, 37 Cal. L. Rev. 539, 540, with J.C. Shepherd, *Towards a Unified Concept of Fiduciary Relationships*, 97 L.Q. L. Rev. 51, 75.

2 Restatement (Second) Trusts § 2.

3 For cases discussing the existence of a fiduciary relationship see *Beery v. State Bar of California*, 739 P.2d 1289 (Cal. 1987) (and cases cited therein).

4 The contours of the fiduciary obligation also serve as a method for distinguishing between different fiduciary relationships. See Deborah A. DeMott, *Fiduciary Obligation under Intellectual Siege: Contemporary Challenges to the Duty to be Loyal*, 30 Osgoode Hall L. J. 471 (1992).

5 *Roselink Investors, LLC v. Shenkman*, 386 F.Supp.2d 209, 215-216 (S.D.N.Y. 2004).

6 *Id.* at 219.

7 *Id.* at 215-216.

8 *Id.*

Duty of Obedience

The duty of obedience is the forgotten duty. In the appropriate context, it requires that a fiduciary obey the directions of its debtor corporation. Of course, a debtor corporation is a legally recognized bundle of relationships, not a tangible element, and can no more shout instruction or convey direction than we can fly. Thus, bankruptcy law, corporate law, the charter, articles of incorporation, the bylaws, shareholder resolutions, and model rules of professional conduct set out the dictates of obedience. Failure to comply with these principles runs afoul of this duty.[9]

Fiduciaries in a Bankruptcy Case

A bankruptcy case includes a multitude of persons with fiduciary duties to a host of, at times, conflicting constituencies. Following is a discussion of some of those parties and their duties.

Fiduciaries of the Estate

The Trustee

There can be no doubt that a bankruptcy trustee is a fiduciary to the estate and of the parties in interest.[10] As a fiduciary, the trustee in a bankruptcy case has an obligation to each of the debtor's creditors[11] and shareholders[12] to act in a reasonably prudent manner and in the best interest of the debtor's estate. The duties and obligations of the trustee are spelled out in sections 704 and 1106 of the Bankruptcy Code.

The Debtor in Possession

In most Chapter 11 bankruptcy cases, no trustee is appointed and the management of the debtor, as debtor-in-possession, is tasked with not only running the ongoing business of the debtor, but also acting as the estate's fiduciary. Pursuant to section 1107 of the Bankruptcy Code, with the exception of certain investigatory responsibilities, the debtor in possession takes on the responsibilities of the trustee.[13] Thus, like the trustee, the debtor in possession has a fiduciary duty to the debtor's creditors as a group.[14] Thus the debtor in possession has not only a duty to do what is in the best interest of the ongoing entity that is the debtor, but also what is in the best interest of the creditors.

The Professionals Employed by the Trustee or the Debtor in Possession

When professionals are hired by a trustee or a debtor-in-possession, it is essential to remember that the client is the debtor's estate – not the trustee and not the management of the debtor in possession. Like the trustee or the debtor in possession, these professionals also appear to be fiduciaries (although the contours and existence of the duty itself is not well-settled),[15] and, as the Bankruptcy Court for the Northern District of Alabama so aptly noted, these professionals

> "[A]re also charged with special responsibilities of insuring that when the interest of the estate conflicts with the interest of the individual who signs his checks, that the interest of the estate prevails."[16]

The contours of these duties are difficult to define, but courts have found that the duties include the duty to inform the court when the debtor-in-possession is incompetent to carry out the duties required of that position[17] or when there is little or no chance of a successful reorganization and continued operations are detrimental to the estate and its creditors.[18]

The Examiner – Fiduciary for the Court?

Like the trustee or the debtor in possession, the court appointed examiner is also a fiduciary in a bankruptcy case. However, unlike the trustee, the party to whom the examiner owes his/her duty is narrow. As the Bankruptcy Court for the Southern District of Ohio artfully noted, "An Examiner's legal status is unlike that of any other court-appointed officer which comes to mind. He is first and foremost disinterested and nonadversarial. The benefits of his investigative efforts flow solely to the debtor and to its creditors and shareholders, but he answers solely to the Court."[19]

For the Parties in Interest

The Bankruptcy Code seems to recognize that in Chapter 11 cases, the debtor in possession has competing loyalties, thus, to ensure that the interests of the creditors are not subjugated to the interests of the debtor, the unsecured creditors and other blocks of interest holders are generally represented by one or more committees with professionals of their own.

The Committee

Generally, a Chapter 11 case gives rise to, minimally, an official committee of unsecured creditors appointed by the United States Trustee pursuant to section 1102 of the Bankruptcy Code and vested with the duties and powers described in section 1103 of the Bankruptcy Code. In large cases, or where the interests of the unsecured creditors are clearly divergent, multiple committees may be appointed (i.e. an equity committee, a bondholder's committee, a franchisee committee, etc.) or subcommittees may be appointed.[20] Members of these committees have a fiduciary duty to the holders of the claims or interests they are appointed to represent. While negotiating on behalf of its constituency and taking steps to keep that constituency informed are among the duties of an official committee, the official committee is not

9 *Cf. Ridder v. CityFed Financial Corp.*, 47 F.3d 85, 87 (3d Cir. 1995).

10 11 U.S.C.A. § 323 (a).

11 "A bankruptcy or reorganization trustee is a fiduciary of each creditor of the estate, including anyone who is a party to an executory contract with the bankrupt. As such, he has a duty to treat all creditors fairly and to exercise that measure of care and diligence that an ordinarily prudent person under similar circumstances would exercise." [internal citations omitted] *In re Cochise College Park, Inc.*, 703 F.2d 1339 (9th Cir. 1983).

12 *Commodity Futures Trading Com'n v. Weintraub*, 471 U.S. 343, 355, 105 S.Ct. 1986, 1994, 85 L.Ed.2d 372 (1985). Note, that the duty seems to be in accordance with priority, thus if the estate is insolvent, the duty to shareholders seems to dissipate.

13 *United States v. Whiting Pools*, 462 U.S. 198, 200 n. 3, 103 S.Ct. 2309, 2311 n. 3 (1983)

14 *Ford Motor Credit Co. v. Weaver*, 680 F.2d 451, 462 n. 8 (6th Cir.1982)

15 *In re Doors and More*, Inc., 126 B.R. 43, 45 (Bankr.E.D.Mich.1991).

16 *In re Harp*, 166 B.R. 740, 746 (Bankr.N.D.Ala. 1993).

17 See *In re Rivers*, 167 B.R. 288, 300 (Bankr.N.D.Ga. 1994) (failure to notify the court that the debtor in possession was incompetent was a breach fiduciary duties warranting the denial of fees). See also *In re James Contracting Group, Inc.*, 120 B.R. 868, 873-74 (Bankr.N.D.Ohio 1990).

18 *In re James Contracting Group, Inc.*, 120 B.R. 868, 873 (Bankr.N.D.Ohio 1990).

19 *In re Hamiel & Sons, Inc.*, 20 B.R. 830, 832 (Bankr.S.D.Ohio 1982). See also *In re Big Rivers Electric Corporation*, 355 F.3d 415, 431-2 (6th Cir. 2004).

20 *In re Refco.*, 336 B.R. 187, 195 (Bankr.S.D.N.Y. 2006).

intended to be only a conduit for the purposes of negotiation and information. Rather the official committee is also intended to be an advocate for the parties it represents.[21]

While, as a general rule, the fiduciary duties of an official committee flow only to its given constituency, it is important to note that these duties do occasionally expand. The most common event which will give an official committee fiduciary duties flowing to the estate and its creditors and parties in interest as a whole is the entrustment of a given cause of action such as the prosecution of a preference or fraudulent transfer claim to the committee.[22]

Professionals for the Committee

Like the trustee or the debtor in possession, official committees are empowered to employ professionals to assist with its duties at the estate's expense. Further, like the professionals employed by the trustee or the debtor in possession, professionals for the committees are also fiduciaries themselves.

What Does Virtue Have to Say About That?

Many professions have struggled with a professional ethic that provides action guidance to individual members while maintaining the profession's collective integrity (e.g., American Bar Association Model Rules of Professional Conduct 2012 and AIRA Code of Professional and Ethical Conduct). As previously discussed, professions have sought comfort in elaborate codes of conduct that purport to regulate and inform members of the profession and, simultaneously, protect the integrity and separateness of the profession (see Part I of this article in AIRA Journal 28:1).

Bankruptcy is no different. Numerous bankruptcy and bankruptcy-related organizations have crafted elaborate codes of conduct, fascinating artifacts in their own right, to inform, and in limited formal means, regulate members of the profession. These professional codes generally emphasize a professional's interaction with the bankruptcy estate, the client, and the court[23] As previously shown, these codes of conduct may provide a floor to ethical conduct, but do they inspire a greater sense of professionalism? I say that they do not; that these codes, although they provide the minimum floor for ethical behavior, are largely deficient because they fail to provide a robust dynamic in addressing ethical issues founded on human relationships and not "things," and fail to provide consistent and coherent action guidance. A new approach is needed.

Generally, virtue ethics is accepted as one of three approaches in normative ethics. The two other approaches are deontology and consequentialism.[24]

Deontology emphasizes duties and rules.[25] Of course, a deontological system need not be rule-bound – think, for example, of a system that required a person to treat others as they would like to be treated – but the curse of multi-dimensionality is ever present. Deontology tends to focus on the means to an action and always remains action-centered. Kantianism is one of the more famous types of deontology.

Consequentialism emphasizes the consequences or ends of actions and always remains action-centered.[26] Utilitarianism, one of the more famous types of consequentialism, seeks to maximize well-being through action.[27] Professionals maximize well-being, for example, by being good stewards of the bankruptcy estate.

Both deontology and consequentialism primarily focus on the actions of humans; character or motives are either irrelevant or derivative. In contrast, virtue ethics emphasizes virtue or moral character.[28] As an ethical system, it focuses on what makes a *bankruptcy professional* good, rather than what makes an *action* good.[29] As a character-centric normative ethic, virtue ethics provides the basis for the development of a dynamic and organic ethical process that informs and guides a professional and his or her profession in the panoply of human relationships that make up the praxis of bankruptcy. Virtue ethics revolves around questions of character, and places emphasis not on professional codes that rest on deontological or utilitarian foundations, but on the subjectivities of social and political interactions.[30] In sum, the most universal concept of the many varieties of virtue ethics is the primacy of character or virtue where action guidance is derivative.

Thus, an action by a bankruptcy practitioner is right if and only if it is what a practitioner with a virtuous character would do. It is an ethical system that is agent, not action, based. Goodness is prior to rightness. And acting virtuous does not require that we maximize the good. Seeking excellence through virtue allows for a right time, a right motive, a right way, with regard to right objectives towards the right people. Complete virtue is not acquired through habitation or reason alone. It is a fusion of character and intellect and experience and reflection. Complete virtue is acquired through observance of exemplars, study of relevant texts and situations, and practice, practice, practice.

"All models that attempt to depict reality are false; some just happen to be useful."[31] This is no less true for professional ethical systems of all types, including those built on virtue. A profession exhibits a specialized expertise, one in which the public or a segment thereof may entrust. Thus, a virtue model based on the virtue of trust – a virtue both fundamental and near-universal to any profession – is useful. Such a model draws from the character of a bankruptcy professional that is both trustworthy and trusting. It demands a focus on relationships with human beings. It does not ignore the importance of the bankruptcy estate, but clearly makes the interest in the estate indirect and deeply subordinate to any human relationship. At its base level, it seeks to answer the question of how does a bankruptcy professional and his or her profession build trust with the all parties in interest, including

[21] *Id*. citing *In re Daig Corp*., 17 B.R. 41, 43 (Bankr.D.Minn.1981).

[22] *Id*. at 195-196 citing *Commodore Int'l Ltd. v. Gould (In re Commodore Int'l Ltd.)*, 262 B.R. F3d 96, 100 (2nd Cir. 2001).

[23] Cf. Sarah Tarlow, *Decoding Ethics*, 4 Public Archaeology 249 (2001), Sarah Tarlow, *The Ethics of Archaeology: Philosophical Perspectives on Archaeological Practice*, in THE ETHICS OF ARCHAEOLOGY: PHILOSOPHICAL PERSPECTIVES ON ARCHAEOLOGICAL PRACTICE, 199-216 (C. Scarre & G. Scarre eds. 2006).

[24] Marcia W. Baron, Philip Pettit, & Michael A. Slote, ETHICAL THEORY: FOR AND AGAINST: CONSEQUENCES, MAXIMS, & VIRTUES, 1-2 (1997).

[25] *Id*. at 3.

[26] Philip Pettit, *Consequentialism*, in A COMPANION TO ETHICS, 230-233 (P. Singer ed. 1991).

[27] Rober Goodin, *Utility and the Good*, in A COMPANION TO ETHICS, 242 (P. Singer ed. 1991).

[28] Baron et al. at 1-9.

[29] *Id*. at 175.

[30] *Id*. at 177-179; Roger Crisp and Michael A. Slote, VIRTUE ETHICS, 24 (1997).

[31] George E. P. Box and Norman R. Draper, EMPIRICAL MODEL BUILDING AND RESPONSE SURFACES, 74, 424 (1987).

the judiciary. It provides guidance on how we ought to conduct ourselves as virtuous professionals.

Virtue ethics may be traced back to at least ancient Greece, beginning with the writings of Plato and Aristotle.[32] In his *Republic*, Plato devotes considerable discussion to four cardinal virtues that make good moral character.[33] These virtues are courage, temperance, wisdom, and fortitude.[34] Central to his moral theory, Aristotle engages in a discussion of virtues.[35] The stoics then apply a body of knowledge developed by a consideration of virtues as indicators of good moral character to their philosophy on ethics. Meanwhile, during the scholastic period, Christian thinkers, particularly St. Thomas Aquinas in his *Summa Theologiae* and *Commentaries on the Nicomachean Ethic*, embrace Aristotle's virtues as essential to Christian moral theology.[36]

After the stoics and the passing of the scholastic period, virtue ethics as a form of normative ethics largely moved into a period of neglect.[37] During this time, other forms of normative ethics eclipsed its importance. Virtue theory was not considered a viable ethical theory for over 2000 years.[38] Recently, because of the perceived fundamental inadequacies of other ethical theories, virtue ethics has experienced a rebirth of sorts, particularly in the context of the development of a meaningful professional ethic.[39]

The primacy of character is the core concept of modern virtue ethics theories. Of course, that does not mean that there is one type of primacy; in fact, there are many different understandings of primacy. However, diversity does not detract from the fundamental role character plays in virtue ethics.

The primacy of virtue may also help us understand the significant differences among the competing moral philosophies from which we draw professional ethics – deontology, consequentialism, and virtue ethics. We can portray these differences among the rival theories by isolating what is basic and what is derivative. By basic we mean what is primary or has priority in a hierarchy of attributes. By derivative we mean what is secondary or subordinate in a hierarchy of attributes.

> The usual story is that deontological theories take deontic concepts [e.g., duty, rightness, and obligation] to be basic, and virtue and value concepts to be in some way derivative. Consequentialist theories are held to take some idea of goodness (of states of affairs) as basic, with virtue and rightness derived from that goodness. Finally, virtue ethics is held to take virtue concepts as basic, with concepts of rightness and obligations, and value as derivative. Thus, 'primacy of the virtues' is the way we are commonly asked to understand what virtue is.[40]

Thus, according to the application of rival theories, one of three types of concepts is given priority and the others are derivative. Primacy then takes on an explanatory function.[41] Applying this idea to virtue ethics would lead us to the following. Because virtue is primary, what is basic is the question of how is it best for a person to be.[42] Based on the primacy of virtue, we can then determine what is proper conduct.[43] Furthermore, "the moral status of acts depends entirely on whether they would be performed by morally good persons or are manifestations of virtue."[44]

Virtue ethics is actually a family of theories. Each theorist has added his or her own distinctive features to the development. There are, however, several central or fundamental attributes largely shared by modern virtue ethics theories that may be helpful in building a professional ethic for archaeology or bankruptcy, for example, which may aid in addressing the complex issues posed by armed conflict. First, virtue ethics holds to the fundamental principle of the primacy of character or virtue. Thus, a professional ethic based on virtue is primarily concerned with how a virtuous trustee or bankruptcy professional ought to act, or refrain from acting, in any given situation. Second, virtue ethics is agent-centered and not rule-or-consequence-centered. Thus, the focus is on the agent, that is, the bankruptcy professional and his or her profession. Third, although agent-centered, any suggestion that virtue ethics is not action-based as well lacks nuance. Actions matter but only in a derivative and not primary manner. Thus, a professional ethic based on virtue ethics has something to say about *why* a bankruptcy professional did what he or she did and *what* he or she did and the consequences thereof. Under this approach, an action is right if and only if that action would be undertaken by the ideally virtuous agent.[45] Therefore, the near universal core concept that unites the vast majority of virtue ethics theories is the primacy of virtue and the derivative nature of action. "An ethics of virtue is not a particular claim about the priority of virtue over right conduct but the more general claim that *action appraisal* is derivative from the *appraisal of character*."[46] The development of virtues in a professional context is a reflective experience of universals and particulars and of generalizations and discrimination. Thus, as a theory of ethics, virtue ethics, with its focus on the importance of context, may capture the distinctive nature of a profession and both *explain* and *justify* why its members do and refrain from doing certain things.

Conclusion

Virtues may be out of style, but they are not outdated. This is particularly true with the virtue of trust in a professional role. For example, a chapter 7 bankruptcy trustee is entrusted with the estate for the benefit of all parties in interest. It is not the estate that a trustee seeks to foster trust with; the beneficiaries of a

32 Greg Pence, *Virtue Theory*, in A COMPANION TO ETHICS, 251-2 (P. Singer ed. 1991).

33 *Id*. at 251.

34 *Id*. at 252.

35 Aristotle, POLITICS, 11-17, 28-47, 63-78, 137-58 (C.D.C. Reeve (trans) 1998).

36 Pence at 252.

37 Baron et al. at 175.

38 *Id*.

39 R.A. Duff, *The virtues and Vices of Virtue Jurisprudence*, in VALUES AND VIRTUES: ARISTOTELIANISM IN CONTEMPORARY ETHICS, 90-104 (T. D. Chappell ed. 2006); Christine Swanton, VIRTUE ETHICS: A PLURALISTIC VIEW, 207-224 (2006); Justin Oakley and Dean Cocking, VIRTUE ETHICS AND PROFESSIONAL ROLES, 71-94 (2001).

40 M. V. Baer, *The Primacy of Virtue in Virtue Ethics*, (Unpublished doctoral dissertation, University of California, Irvine) 10 (2005)(internal citations omitted).

41 Id. at 11

42 Id.; Gary Watson, Appropriate Emotions, 75(11) Journal of Philosophy 699 (1978).

43 Gary Watson, *On the Primacy of Character*, in IDENTITY, CHARACTER, AND MORALITY: ESSAYS IN MORAL PSYCHOLOGY, 451 (O. J. Flanagan & A. Rorty eds. 1990).

44 Phillip Montague, *Virtue Ethics: A Qualified Success Story*, 29(1) American Philosophical Quarterly 54 (1992).

45 Rosalind Hursthouse, *Virtue Ethics*, THE STANFORD ENCYCLOPEDIA OF PHILOSOPHY, 28 (E. N. Zalta ed. Summer 2012 Edition). http://plato.stanford.edu/archives/sum2012/entries/ethics-virtue/ (available as of July 8, 2013).

46 Watson, *On the Primacy of Character* at 452 (emphasis in the original).

trustee's acts of trust-making are the parties in interest, including the judiciary. A trustee administers the estate for their benefit acting as a virtuous agent, promoting the virtue of trust, being both trusting and trustworthy, and engaging in trust-making actions that promote attributes of competence, loyalty, good faith, and, where appropriate, obedience.

The post-Watergate ethical turn of the 1970s inadvertently replaced exemplars with codes as our primary source of learning ethical behavior. That is certainly not the only, and may not be the better, approach. Rather, seek out a teacher and emulate, ask, and learn – the AIRA Annual Meeting and its Regional Meetings are great places to seek these professional relationships. This is not a mindless process of mimicking a mentor. Student and teacher engage in a time-honored and robust process where both have much to give and both internalize the professional experience. It is a constant, reiterative process. And it is a life-long challenge; but you will be the richer if you refuse to abandon the quest. In the end, professional virtue is not a destination, but a journey well lived.

To be sure, codes of ethics – many of which are mandatory – are not vacating the scene soon; thus, a bankruptcy professional must continue to abide by them. However, ethical codes – even mandatory ones – are not the full measure of professionalism. There may be something more, a place for virtue, that may give the practice of bankruptcy a human face.

I leave you with the wisdom of an intergenerational exemplar, one whose lessons on professionalism and virtue contain a treasure trove of wisdom.

> Mr. Lincoln, seated at the baize-covered table in the center of the office, listened attentively to a man who talked earnestly and in a low tone. After being thus engaged for some time Lincoln at length broke in, and I shall never forget his reply. "Yes," he said, "we can doubtless gain your case for you; we can set a whole neighborhood at loggerheads; we can distress a widowed mother and her six fatherless children and thereby get for you six hundred dollars to which you seem to have a legal claim, but which rightfully belongs, it appears to me, as much to the woman and her children as it does to you. You must remember that some things legally right are not morally right. We shall not take your case, but will give you a little advice for which we will charge you nothing. You seem to be a sprightly, energetic man; we would advise you to try your hand at making six hundred dollars in some other way. [47]

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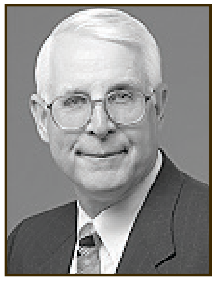
[47] William H. Herndon and Jesse William Weik, Herndon's Lincoln: The True Story of a Great Life 345-346 (1889).



Bankruptcies Which Changed the U.S. Economy: Part 1

Forrest Lewis, CPA
Section Editor

This article highlights some of the bankruptcies and near-bankruptcies which caused a major change in the United States economy—either financial, political or legal. This article is not a history of bankruptcy law per se but focuses instead on cases which had wider repercussions in the US economy. As you will see, certain key bankruptcies down through history brought about major changes in economic practice, political power, market regulation and bankruptcy legal procedure:

1832—Closure of the Second National Bank

this is not a bankruptcy per se but had a major impact on the US economy for 80 years. The abolition of the National Bank by Andrew Jackson and the Jacksonian Democrats is often portrayed as a cause of economic disaster, but some economic historians see it as a very justifiable reaction to gross mismanagement of the money supply by the National Bank administrators.[1] After abolition, the deposits were farmed out to numerous state banks and no central US bank was established until the Federal Reserve Act of 1913. Between 1815 and 1818 the National Bank's assets had ballooned from $2 million to $21 million which accompanied a national inflation rate of 60% over that period. Realizing the extent of the inflationary crisis, the National Bank wheeled about and reduced its assets to $11 million in 1819, contributing to a massive national deflation. This whipsaw created great national pain and the reputation of the National Bank never recovered, leading to Jackson's successful campaign against it. Subsequently, though, the US lacked the economic policy tool of a central bank which Great Britain and other major powers possessed for the next 80 years.

1873—The Bankruptcy of Jay Cooke & Co.

One of the unsung heroes of the Civil War was Jay Cooke from Sandusky, Ohio. In concert with Secretary of the Treasury Salmon P. Chase, he successfully helped sell over $1 billion in Union war bonds using what are considered some of the first national marketing techniques involving newspaper ads, handbills, posters and reporting by telegraph.[2] In the process, he became wealthy and his bank, Jay Cooke & Co., became pre-eminent in its field of bond underwriting. In 1870 he got involved in the post-Civil War "arms race" to build railroads by becoming heavily invested in the Pacific Northern Railway, which was trying to link the Great Lakes with Puget Sound, Washington. However, due to a spreading worldwide financial panic in 1873, the bank was unable to sell enough bonds for the railway which caused the bank to fail and Cooke to lose control of the railway. The Panic

[1] Rothbard, M. (2005). *A History of Money and Banking in the United States,* pp. 86-93.

[2] *Ibid* p 134.

of 1873 hardened into an extended crisis known as the "Great Depression" until the 1930s.

The failure of the Jay Cooke bank set off a chain reaction of bank failures and temporarily closed the New York stock market for 10 days. Factories began to lay off workers as the United States slipped into depression. The effects of the panic were quickly felt in New York, and more slowly in Chicago, Virginia City, Nevada, and San Francisco. Some 115 of the nation's railroads failed. Construction of new rail lines, formerly one of the backbones of the economy, plummeted from 7,500 miles of track in 1872 to just 1600 miles in 1875. 18,000 businesses failed between 1873 and 1875. Building construction was halted, wages were cut, real estate values fell and corporate profits vanished. In 1877, steep wage cuts led American railroad workers to launch the Great Railroad Strike. President Rutherford B. Hayes sent in federal troops to try to stop the strikes and more than 100 people died in the ensuing melees. In July 1877, the market for lumber crashed, sending several leading Michigan lumbering concerns into bankruptcy. One result was that public sentiment turned against the Republican party in the White House and restored the Democrats to a very competitive position for decades.[3]

1893—"Take a Ride on the Reading"

The Panic of 1893 was the largest economic depression in U.S. history at that time. While the crisis began overseas, in large part due to failure of the Baring Brothers Bank of London, one of the first clear signs of trouble in the US came on February 23, 1893, with the bankruptcy of the Philadelphia and Reading Railroad, which had greatly overextended itself. In a reprise of the Panic of 1873, in the overbuilt and shaky rail industry, many railroads failed which then set off a series of bank failures. One-quarter of U.S. railroads had failed by mid-1894, representing over 40,000 miles including the Northern Pacific Railway (again), the Union Pacific Railroad and the Atchison, Topeka & Santa Fe Railroad. Acquisitions of the bankrupt companies led to further consolidation of ownership. As of 1906, two-thirds of the rail mileage in the U.S. was controlled by seven entities, with the New York Central, Pennsylvania Railroad and Morgan having the largest portions.

As a result of the Panic, stock prices declined. 500 banks were closed, some of them after dramatic "runs on the bank" captured for the first time in history in photographs. Midwest banks were particularly hard hit as Chemical National Bank and Columbia National Bank in Chicago folded plus the National Bank of Kansas City. 15,000 businesses failed and people chopped wood, broke rocks, and sewed in exchange for food. The severity was great in all industrial cities and mill towns. Farm distress was great because of the falling prices for export crops such as wheat and cotton. Many Western silver mines closed. The unemployment rate in Pennsylvania hit 25%, in New York 35%, and in Michigan 43%. Soup kitchens were opened in order to help feed the destitute.[4]

The extreme number of bankruptcies led to the federal 1898 Bankruptcy Act. While there had been various attempts to establish a federal bankruptcy law since 1800 all of which were eventually repealed, the 1898 Act became the first "permanent" federal bankruptcy law. This Act brought in the modern era of liberal debtor treatment, eliminating most conditions for discharge and qualifying most types of debt for discharge. It also established a system of bankruptcy administration throughout the country. The Supreme Court was given power to create forms and rules. District courts were delegated power to hear bankruptcy cases and "referees" were established who were later upgraded to bankruptcy judges.[5] Another fall out of the 1893 Panic was the strengthening of bank regulation. For several decades thereafter, regulators pushed for tightened capital and liquidity requirements on banks.

1929—The Hatry Group and the Stock Market Crash

While the ultimate causes of the stock market crash of October, 1929 were fundamentals such as excessive leverage, shoddy securities practices and heavy handed changes in central bank policy, the immediately precipitating event, like some earlier panics, occurred overseas. Clarence Hatry was an English investor with a checkered financial past but was known for his grand manner of living. In the late 1920s, he built an empire with investments in photographic supplies, cameras, vending machines, and loan offices. In 1928 Hatry owned photograph machines in hundreds of public places such as railway stations and amusement parks throughout Britain. In early 1929 investors flocked to the Hatry group of companies, partly because of the participation of some members of the English nobility. Hatry then embarked his greatest venture, a merger of steel and iron concerns into the $40 million United Steel Companies. Just as this deal was to be consummated, the London Stock Exchange Committee caught him borrowing $1 million on worthless paper. On September 20, 1929, the fraud became known leading to the indictment of Hatry and his associates. When his financials were scrutinized, they were found to show a huge deficit, leading to the collapse of his empire. Unfortunately, this led to a drop in the London Stock Exchange which was later echoed on Wall Street. Starting on Black Thursday, October 24, the New York Stock Exchange dropped 25% in four trading days.

The crash led to the Great Depression. During the Depression, unemployment rose to 25%, wages fell 42%, economic growth fell 50%, and world trade plummeted 65%.[6] The Dow did not reach its 1929 level again until 1954. Needless to say, most readers will be familiar with many of the effects of the Great Depression on the US in terms of ascendancy of the Democrat Party, lasting elements of the New Deal legislation, the Social Security Act, etc., etc.

In Part II we will explore the period between 1930 and today.

Bankruptcy Taxes

Tax Case Highlights Importance of Designating Tax Payments

A recent tax court case illustrates the absolute importance of making a designation as to how IRS is to apply any payment of a tax, especially delinquent taxes. Under Revenue Procedure 2002-26 IRS will generally apply a payment in the manner and to the periods designated in writing by the taxpayer at the time the payment is made. However, in the absence of a designation by the taxpayer, under that same Revenue Procedure, the IRS will apply a payment to tax, then penalties, then interest, in that order and to the periods "in the best interest" of the IRS. The latter means in a

3 The Panic of 1873, *Wikipedia*.
4 The Panic of 1893, *Wikipedia*.

5 Tabb, Charles Jordan, The History of the Bankruptcy Laws in the United States (1995). American Bankruptcy Institute Law Review , Vol. 3, p. 5, 1995. Available at SSRN: http://ssrn.com/abstract=2316255
6 The Stock Market Crash of 1929, *About.com*.

manner to maximize the tax ultimately collected. First, a taxpayer should designate what type of tax is being paid (corporate income tax, withholding, etc.) and if there are delinquent taxes, the order in which payments are applied to tax, penalty and since the IRS will apply payments to penalties before interest and it is very difficult to get interest abated but easier to get penalties abated. Also, the taxpayer should designate the period to which a payment is applied. IRS will generally want to apply payments to the oldest period to satisfy that before the statute of limitations on collection runs, thus keeping the most recent periods "fresh" for collection. Also, a taxpayer may have received a discharge in bankruptcy for taxes for certain periods but IRS may attempt to apply any unspecified payment made to those periods.

The recent ruling actually involved two cases of a husband and wife, James R. Dixon v. Commissioner and Sharon C. Dixon v. Commissioner, U.S. Tax Court, Dkt. No. 9962-05L, 9965-05L, TC Memo. 2013-207, September 3, 2013. The Dixons, like many small corporation owners, fell behind in remitting their withheld employee payroll taxes and the Dixons failed to file personal income tax returns for the years 1992-5. The IRS prosecuted them in criminal court for the unfiled personal income tax returns representing $500,000 in unpaid personal income tax. The latter step is a little unusual but it may have been taken by IRS to gain leverage on the corporate payroll tax liability of $23 million. The taxpayers extricated themselves from the unpaid personal income tax liability as follows. They hired a shrewd attorney who directed them to borrow on the equity in their home to raise $500,000 which they then contributed to their corporation. The corporation in turn remitted that amount to the IRS with a designation that it represented the unpaid withholding for the Dixons. Since the taxpayers had taken checks with no withholding from the corporation, after some flip-flopping, the IRS stated the taxpayer could not credit this voluntary payment to just one employee's withholding. In addition, the Dixons had argued that the $500,000 should be credited as timely paid in the 1992-5 period, thus reducing penalties and interest. While the Tax Court ruled against the Dixons on the retroactive timing, it did require IRS to follow its own Revenue Procedure and credit the $500,000 as specifically representing the Dixons' personal withholding, thus abating the Dixons' personal income tax liability for their personal returns for those years.

Conclusion: This case illustrates the extreme importance of strategically designating in the taxpayer's favor in writing accompanying any tax payment the type of tax and period, and if applicable, the amount to be credited to tax, interest or penalty.

Recent Court Decisions Include Health Savings Accounts in Property of Bankruptcy Estate

While many cases have been litigated concerning the ability of trustees to reach Individual Retirement Accounts in Chapter 7 individual cases, only a few have been decided on Health Savings Accounts, undoubtedly due to their smaller relative amounts. Health Savings Accounts and Medical Savings Accounts are tax favored trust savings accounts created under the Internal Revenue Code "owned" by individuals. Generally contributions are tax deductible or tax exempt when made by an employer and distributions not taxable when used to pay qualifying medical expenses. Because the contribution limits have historically been much lower than those for IRAs, the amounts accumulated are usually much smaller.

Lately a number of courts have addressed cases of an individual filing a petition in Chapter 7 who owns an HSA and seeks to exempt it from the property of the bankruptcy estate under an exemption similar to that for Individual Retirement Accounts. Some states allow only the federal exemptions from the bankruptcy estate and others only those enumerated by the state and yet another sizeable group allow an individual to elect either the federal or state exemptions. The leading case on the federal exemption is In Re Leitch, Bankruptcy Appellate Panel for the Eighth Circuit, No. 13-6009, July 16, 2013 which decided there is no federal exemption for a Health Savings Account. Some states do specifically allow exemption for HSAs and MSAs. However, in a recently decided case, a Georgia Bankruptcy Court ruled the debtor was not entitled to claim exemption of her health savings account from the bankruptcy estate because the HSA was not the type of illness benefit or right to receive payment on account of illness contemplated under Georgia law. (In re Mooney, BC-DC Ga., Jan. 10, 2014)

Conclusion: in order to exempt an HSA in a Chapter 7 case, an individual must look to state law to see if an exemption is allowed. As things now stand, there is no federal exemption. Presumably MSAs will be governed by the same rules.

IRS Explains Treatment of Mortgage Settlement Fund Payments

In 2012, the United States government and the attorneys general of 49 states and the District of Columbia entered into settlement agreements with five bank mortgage servicers to address mortgage loan servicing and foreclosure abuses ("National Mortgage Settlement"). One component of the National Mortgage Settlement is the Borrower Payment Fund, which the parties intend to be structured as a qualified settlement fund under §1.468B-1 of the Income Tax Regulations.

Under Revenue Ruling 2014-2, a taxpayer who receives a payment due to the foreclosure of the taxpayer's principal residence will include the payment in the amount realized on the foreclosure (sale) under Code Sec. 1001, the IRS determined. If a taxpayer includes a payment in the amount realized and, as a result, creates or increases a gain on the foreclosure of the principal residence, the taxpayer may exclude the resulting gain from gross income to the extent permitted under Code Sec. 121, the familiar $250,000/500,000 personal residence exclusion. To qualify for that, generally a taxpayer must have lived in the residence for two years of the last five. In the majority of cases, the mortgage settlement payments will be nontaxable under Sec. 121 or will reduce a nondeductible tax loss. However, there is an adverse exception in Sec. 121 for gain attributable to depreciation which cannot be excluded from gross income and which can cause taxable gain.

The IRS further explained that if the property for which a taxpayer receives a payment contained one or more additional dwelling units that were not used as the taxpayer's principal residence, the entire payment is allocable to the portion of the property that the taxpayer used as a principal residence. The ruling contains seven examples illustrating various gain and loss situations.

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Bankruptcy Cases

Professor Baxter Dunaway
Section Editor

Sixth Circuit Court of Appeals In re Lindsey Decision

In re William Edwin LINDSEY, Debtor. William Edwin Lindsey, Appellant v. Pinnacle National Bank, Firstbank, and Value Recovery Group, Appellees. No. 12–6362. Argued July 30, 2013; decided and filed August 13, 2013.

Background

Creditors objected to confirmation of the proposed Chapter 11 reorganization plan on ground that the plan allowed the individual debtor to retain property that he owned on the petition date in violation of absolute priority rule. The Bankruptcy Court, 453 B.R. 886, denied confirmation; the Debtor appealed. The United States District Court for the Eastern District of Tennessee, Tena Campbell, J., 2012 WL 4854718, affirmed; the Debtor appealed. The Court of Appeals Circuit Judge, Sutton, dismissed the appeal, holding the decision denying confirmation of a proposed Chapter 11 plan is not a final, appealable order.

Summary

Lindsey filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code in April 2010. His reorganization plan identified twelve classes of creditors. Because Lindsey sought to retain a majority of his assets, including several pieces of real property, through the proposed plan, three banks—Pinnacle National Bank, First Bank and Mountain National Bank, all impaired creditors—opposed the plan, insisting that it did not satisfy the requirements for a "fair and equitable" plan. 11 U.S.C. § 1129(b)(1). The banks focused on one feature of the plan—that it did not comply with the absolute priority rule, which bars debtors from retaining any property unless the reorganization plan pays all dissenting creditors in full. 11 U.S.C. § 1129(b)(2)(B)(ii); see Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 202, 108 S.Ct. 963, 99 L.Ed.2d 169 (1988). Lindsey responded that the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 abrogated the absolute priority rule with respect to individual debtors. The bankruptcy court disagreed and refused to confirm Lindsey's plan, concluding that the absolute priority rule applies to individual Chapter 11 debtors. The district court affirmed and Lindsey sought review of that order.

The parties' focus on the absolute priority rule obscured another question: Does a district court's rejection of a plan of reorganization create a final appealable order? The Court of Appeals found it necessary to address the issue of jurisdiction before approaching the merits questions of the case. The Court examined the two general paths set forth by Congress for appealing a bankruptcy decision to a court of appeals: One provides jurisdiction to hear appeals from "final judgments, orders, and decrees" by district courts or bankruptcy appellate panels. 28 U.S.C. § 158(d)(1); see 28 U.S.C. § 1291 (permitting appeals in all civil cases from "final decisions" of the district courts); see also Fed.R.Civ.P. 54(b) (permitting district courts in multi-claim, multi-party cases to "direct entry of a final judgment" as to one or more claims or parties if the court finds there is no reason for delay). The other permits review of interlocutory orders properly certified and accepted. Under this second provision, the district court (or bankruptcy appellate panel or bankruptcy court) itself may certify, a party may request the court to certify, or the parties together may certify that: (1) the order implicates a question of law on which there is no "controlling" authority and it involves a "matter of public importance"; (2) the order implicates a legal question "requiring resolution of conflicting decisions"; or (3) an immediate appeal from the order will "materially advance" the case. 28 U.S.C. § 158(d)(2); see id. § 1292(b) (allowing a district court to certify for immediate appeal an interlocutory order that "involves a controlling question of law as to which there is substantial ground for difference of opinion" when "an immediate appeal from the order may materially advance the ultimate termination of the litigation"). Once such a certification occurs, the court of appeals may in its discretion accept the certification—and appeal. Id.

In this instance, the district court did not enter a "final judgment" under Civil Rule 54, and no one sought certification under § 158(d)(2) or § 1292. That leaves the question whether the district court's decision—rejecting a proposed plan of reorganization—nonetheless amounted to a "final" order.

Several steps have been taken down the road to resolving this issue. Attempting to bring some clarity to the area, Settembre v. Fidelity & Guaranty Life Insurance Co. held as a general matter that a district court order remanding a case to a bankruptcy court is not final for purposes of § 158(d)(1) unless the remand is "of a ministerial character." 552 F.3d 438, 442 (6th Cir.2009). Consistent with this approach, parties subject to non-final orders are required either to obtain a finality certification from the district court as to some of the claims or parties in the case under Civil Rule 54(b), or to seek permissive interlocutory review of the order under 28 U.S.C. §§ 158(d)(2), 1292. See Settembre, 552 F.3d at 441; see also In re Brown, 248 F.3d 484, 488 (6th Cir.2001). "[F]inal judgments, orders, and decrees" under § 158(d)(1), the Court stated, must indeed be final, mirroring understanding of finality under § 1291. Settembre, 552 F.3d at 441. In essence, the Court found no good reason to have "final" mean one thing in the former cases and another in the latter." Id.; see Conn. Nat'l Bank v. Germain, 503 U.S. 249, 253, 112 S.Ct. 1146, 117 L.Ed.2d 391 (1992) (comparing § 158(d) and § 1291 and noting that they both confer jurisdiction over "final decisions").

According to this understanding of finality, the Court found that a decision rejecting a confirmation plan is not a final order appealable under § 158(d)(1), because "far more than a few ministerial tasks remain to be done after such a decision." The Court reasoned that unless Lindsey abandoned his petition, he could (or must) propose another confirmation plan, which creditors may or may not support; which may or may not require further fact finding and which the bankruptcy court may or may not exercise its discretion to confirm. Nothing about these tasks is mechanical or ministerial leaving only the job of executing the judgment—only after these positions are taken and decisions made may a party appeal—whether under § 158(d)(1) (because there is a final decision confirming the plan) or under § 158(d)(2) (because the court or parties successfully seek certification of a decision refusing to confirm the plan).

In reaching its decision, the Sixth Circuit Court of Appeals joined four other circuits. See In re Lievsay, 118 F.3d 661, 662–63 (9th Cir.1997) (per curiam); In re Lewis, 992 F.2d 767, 773–74 (8th Cir.1993); In re Simons, 908 F.2d 643, 644–45 (10th Cir.1990); In re Maiorino, 691 F.2d 89, 90–91 (2d Cir.1982). Notably, these other circuits reached this conclusion before Congress amended the Code in 2005 to add § 158(d)(2), see Bankruptcy Abuse

Prevention and Consumer Protection Act of 2005, Pub.L. No. 109–8, § 1233, 119 Stat. 23, 202–03 (2005), and thus to give the explicit option of an interlocutory appeal to a court of appeals in a bankruptcy case.

As to three other circuits that have gone the other way, the Sixth Circuit did not find their explanations convincing. See Mort Ranta v. Gorman, 721 F.3d 241, 245–50, No. 12–2017, 2013 WL 3286252, at *3–6 (4th Cir. July 1, 2013); In re Armstrong World Indus., 432 F.3d 507, 511 (3d Cir.2005); In re Bartee, 212 F.3d 277, 283 (5th Cir.2000). One of these explanations is that bankruptcies demand a "flexible" approach to finality given the number of parties involved and the number of issues at stake. See Mort Ranta, 721 F.3d at 247–48, 2013 WL 3286252, at *5. Yet, as the Supreme Court discussed in construing § 158(d) and § 1291 in another bankruptcy case, the key question is what the statute says about jurisdiction, not what the area regulated by Congress may demand. See Germain, 503 U.S. at 253–54, 112 S.Ct. 1146 ("[C]ourts must presume that a legislature says in a statute what it means and means in a statute what it says there.").

The flexibility needed to manage bankruptcy cases, at any rate, has not been lost on Congress. In the companion subsection to § 158(d)(1), Congress gave parties and courts flexibility to certify issues for appeal if doing so would help settle a novel legal question, resolve conflicting decisions or "materially advance the progress of the case." 28 U.S.C. § 158(d)(2)(A). Civil Rule 54(b) permits a district court to certify as "final" for § 158(d)(1) and § 1291 purposes the resolution of a claim or the entry of judgment for or against a party. The courts have already accounted for the fact that a "case" within a bankruptcy proceeding may be final for these and potentially other purposes even if the entire bankruptcy proceeding has not ended. A bankruptcy proceeding, as the Court points out, involves a " 'congeries of functionally distinct cases,' " the resolution of some of which (say a third-party adversary action) may create a final decision. Settembre, 552 F.3d at 441 n. 1 (quoting In re Lopez, 116 F.3d 1191, 1193 (7th Cir.1997)). Section 1292 also permits the immediate appeal of injunction orders, including those arising in all manner of situations in a bankruptcy proceeding. See United Airlines, Inc. v. U.S. Bank N.A., 406 F.3d 918, 923 (7th Cir.2005); In re Prof'l Ins. Mgmt., 285 F.3d 268, 282 n. 16 (3d Cir.2002); see also Germain, 503 U.S. at 252 & n. *, 112 S.Ct. 1146. Keep in mind, moreover, that parties already have a right to one round of appellate review through § 158(a)(3), which allows district courts to take appeals of interlocutory orders "with leave of the court" and without certification. There is in short flexibility aplenty in this area.

The minority view also argues too much. If, as these circuits claim, a district or bankruptcy court order may be deemed final solely because of "practical considerations in the interests of judicial economy" or because of the need "to quickly resolve issues central to the progress of a bankruptcy," Armstrong World Indus., 432 F.3d at 511, then § 158(d)(1) leaves no work for § 158(d)(2) to do. See Mort Ranta, 721 F.3d at 257–58, 2013 WL 3286252, at *13 (Faber, J., dissenting). Why certify such issues for appeal if "final" in § 158(d)(1) covers them anyway? And why add § 158(d)(2) to the Code in 2005 if § 158(d)(1) already did the work?

Other explanations for the minority view also do not go far. One court thought it strange that a debtor would have to propose a new plan he doesn't want in order to get review of the old plan he favors. See Bartee, 212 F.3d at 283. But that may not happen. The debtor and his creditors may successfully negotiate a new plan agreeable to all parties, eliminating any appeal at all. See In re Zahn, 526 F.3d 1140, 1143 (8th Cir.2008). And if the opposite happens, if the debtor must appeal a confirmed plan with which he disagrees, that leaves even odds that the court of appeals will either approve the plan (and end the case then and there) or reject the plan but announce a rule of law that will allow final (and usually prompt) resolution of the case.

Another court thought it strange that a creditor would get immediate review of a plan confirmation but a debtor would have to wait to challenge a plan rejection. See Mort Ranta, 721 F.3d at 249–50, 2013 WL 3286252, at *6. But this kind of thing happens all of the time in appellate litigation. A civil plaintiff for example may immediately challenge a grant of summary judgment to a defendant, but a defendant who loses his motion usually has to wait until after trial for appellate review. To say one class of parties may challenge final decisions while another class of parties has to wait to argue interlocutory decisions says nothing about whether those decisions are properly treated as final or not.

What of the reality that bankruptcy rules are supposed to be debtor friendly? Maiorino, 691 F.2d at 95 (Lumbard, J., dissenting). Not invariably. Congress added § 158(d)(2) to the bankruptcy code as part of its 2005 amendments, which few would call pro-debtor in the main. See H.R.Rep. No. 109–31, pt. 1, at 4 (2005) (expressing the concern that "bankruptcy relief may be too readily available and is sometimes used as a first resort, rather than a last resort"). Section 158(d) draws the line between appealable and non-appealable interlocutory orders, and courts should not redraw it to favor one or another group of litigants. Lindsey at all events has hardly been cut adrift without recourse. Before filing this appeal, the parties did not seek certification to appeal the bankruptcy court's decision. While the Sixth Circuit Court of Appeals acknowledges that, after oral argument in this appeal, the district court entered an order granting the parties' joint motion for certification in accord with § 158(d)(2), the district court lacked jurisdiction over the case at that time and also failed to take into account the limits of § 158(d)(2)(E). The resolution of this case required the Appeals Court to dismiss the appeal for lack of jurisdiction and to vacate the district court's decisions for lack of jurisdiction.

C.A.6 (Tenn.), 2013.
In re Lindsey726 F.3d 857

Comments

The Sixth Circuit decision could have broad implications for debtors and creditors in complex Chapter 11 cases. Although denials of plan confirmations in such cases are rare, the decision adds weight to incentives for plan proponents to increase efforts to win over potential opponents and to shop jurisdictions to increase likelihood of more favorable outcomes. In addition, with the Sixth Circuit joining the roster of Circuit Courts holding that denials of plan confirmations are not reviewable under section 158(d)(1), the matter may soon find its way onto the Supreme Court's docket.

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