AIRA | Association of Insolvency & Restructuring Advisors

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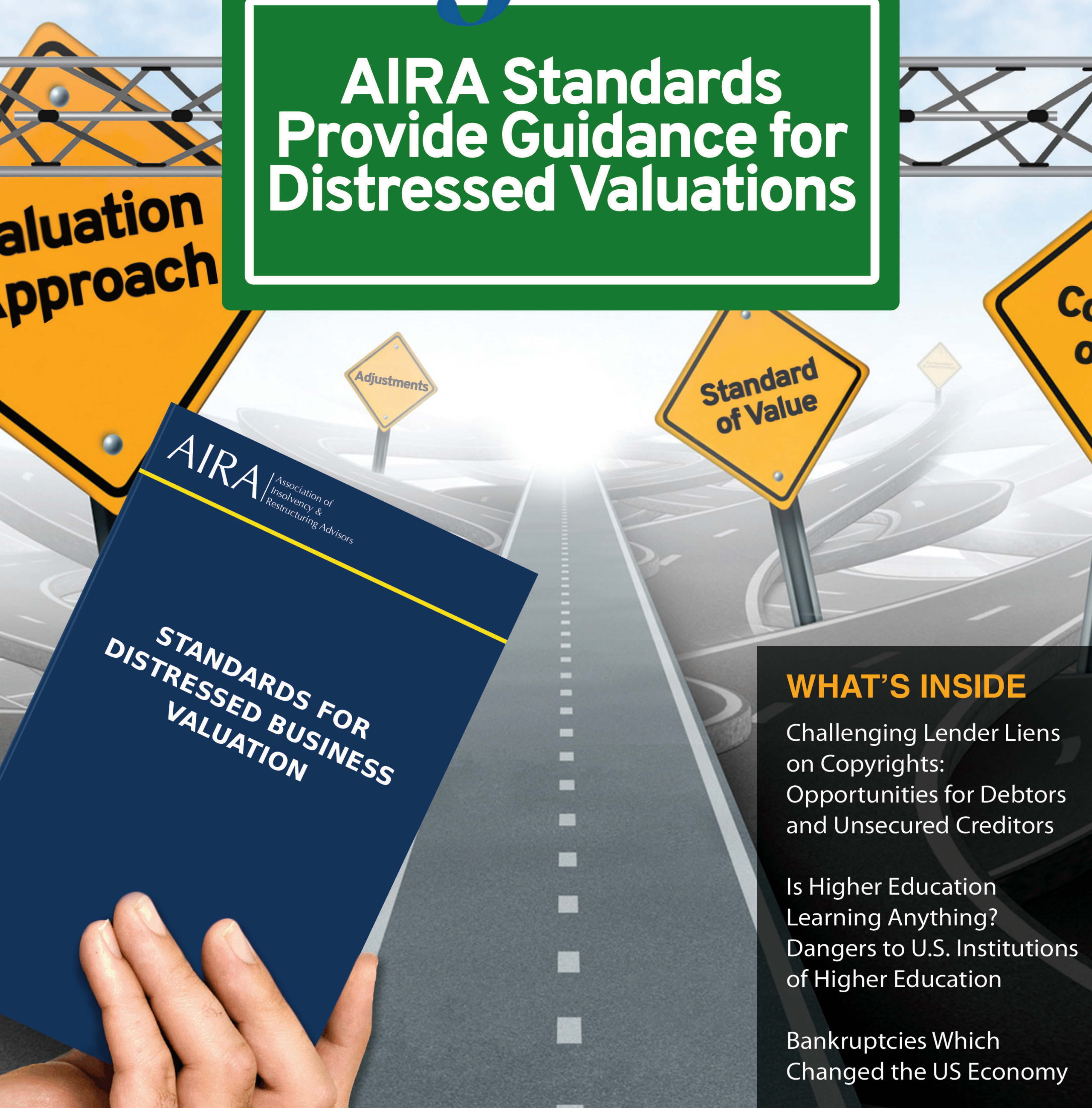
AIRA Standards Provide Guidance for Distressed Valuations



WHAT'S INSIDE

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AIRA Journal is published four times a year by the Association of Insolvency and Restructuring Advisors, 221 Stewart Avenue, Suite 207, Medford, OR 97501.

Michael Lastowski - Editor

MATTHEW SCHWARTZ, CIRA
Bederson LLP

Happy Autumn! Here in NJ as I write, the leaves are beautiful but the weather is turning colder quickly.

For all those who missed this year's NCBJ, we again had a packed house for the opening reception which we host every year. On Friday morning **Steve Darr** (**Mesirow**) moderated an excellent session covering the U.S. Trustee's recent fee guidelines. He was joined on the panel by **Guy A. Davis** (**Protiviti**) and **James L. Patton** (**Young Conaway**) for a lively and informative discussion covering the objectives, challenges and misperceptions about the guidelines along with observations on how to effectively deal with them within our practices.

On November 17, we held our 13th Annual Advanced Restructuring & POR Conference in NYC, at the Union League Club. Thanks as always to **Brian Ryniker** (**CBIZ**) and **Walter Greenhalgh** (**Duane Morris**) for putting together this program. Nearly all participants remained after the conference for cocktails and a tribute to the **Hon. Donald H. Steckroth, USBJ, D.NJ**, for his distinguished service on the bench.

At both of the above events, the audience was lively and asked many insightful and thought-provoking questions. We appreciate the support of everyone who participated.

We also have a number of exciting events coming up you won't want to miss.

First up is our series of webinars. As the year draws to a close and you need those extra CPE credits, these 1-2 hour courses are inexpensive, informative and the ultimate convenience–you don't even have to leave your desk! Keep on the lookout for your weekly **AIRA Advisor** for upcoming sessions. If you're not receiving the weekly updates, just contact the office to sign up.

In January we will be joining the **New York Institute of Credit** and other organizations co-hosting the Big Game Super Networking event at the Hilton Newark Penn Station followed the next day by our 10th Annual joint event at Arno Ristorante in NYC (see p.4).

In January, for the first time we will be participating in **TMA's Distressed Investing Conference** in Las Vegas February 11–13 followed two weeks later by **Valcon 2015** on February 25–27, again in Las Vegas.

Whew! If that's not enough, planning is far along for our 31st annual conference taking place in Philadelphia June 3 – 6 at the Ritz-Carlton. Led by conference co-chairs **Charles Persing** (**Bederson LLP**), **Angela Shortall** (**Protiviti**) and **Joel Waite** (**Young Conaway**) along with Judicial co-chairs **Hon. Rosemary Gambardella, USBJ D.NJ** and **Hon. Kevin Carey, USBJ D.DEL**, our conference is shaping up to be among our best. While the agenda is not completely finalized, you can count on great educational and social experiences, with high profile keynote speakers, coverage of the latest important happenings in our profession and opportunities to visit many of the historical landmarks of the area, including the Liberty Bell, Independence Hall, The National Constitution Center, The Betsy Ross House, The Declaration House (where Thomas Jefferson rented rooms and drafted – you guessed it – The Declaration of Independence), Benjamin Franklin's grave (which I try to visit whenever I'm there), the Philadelphia Zoo and many others (Cheesesteaks!) Although Judge Carey has denied the motion for Duck Boats as an activity, we will be scheduling fun alternative social events along with sessions by leading practitioners.

As I related in the last issue of the AIRA Journal, in 2013 the Board started the Grant Newton Educational Endowment Fund. Thanks to generous contributions from the Board and our members, we have raised over $65,000. Please note that there is now a line on your membership renewal where you can make a voluntary contribution. Please consider a gift as you renew your membership for the coming year. There is no minimum and all contributions are gratefully received. The first Endowment Fund projects will be chosen in2015.

As always, if you have any questions, comments or suggestions about anything at all regarding the AIRA or even just want to chat, I would be more than interested in hearing from you by e-mail, by phone or best of all in person at one of our events. I hope to see you soon.

AIRA | Association of Insolvency & Restructuring Advisors

NYIC
NEW YORK INSTITUTE OF CREDIT
FOUNDED IN 1918

JANUARY 29, 2015

10th Annual NYIC/AIRA Joint Bankruptcy and Restructuring Event

Arno Ristorante - 141 W. 38th St. New York, NY

SESSION 1 - GAME CHANGERS

This panel will address Judge Drain's decision in Momentive regarding cram down, Judge Chapman's decisions in Barnet and Rede regarding Ch. 15, and the ABI Ch. 11 Commission Report.

SESSION 2 - HOT TOPICS IN BANKRUPTCY AND REORGANIZATION

In this session we will discuss the latest bankruptcy court decisions and their impact on the industry as a whole, as well as trends and other important bankruptcy events.

1.5 CPE CREDITS WILL BE AVAILABLE PER SESSION

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Hon. Donald J. Steckroth Receives AIRA Judicial Service Award

At its 13th Annual Advanced Restructuring & POR Conference in New York, November 17, 2014, AIRA's 2014 Judicial Service Award was presented to the Honorable Donald H. Steckroth, U.S. Bankruptcy Judge for the District of New Jersey. With over 75 in attendance for a reception in his honor, Judge Steckroth's contribution to the field was recognized by several speakers including AIRA President, Matt Schwartz, CIRA (Bederson LLP); Walter J. Greenhalgh (Duane Morris LLP); and two other Bankruptcy Judges, Hon. Rosemary Gambardella (Dist. of NJ), and Hon. Kevin J. Carey (Dist. of Del.). All commented at length about Judge Steckroth's outstanding example and influence.

Judge Steckroth graduated from Seton Hall University with a Bachelor of Arts in Accounting in 1969, and from Seton Hall Law School, cum laude, in 1972. Upon graduation Seton he was the law clerk to New Jersey Supreme Court Justice Alan Handler from 1972-73. After serving a judicial clerkship with New Jersey Supreme Court Justice Alan Handler, he joined the New Jersey law firm now known as Gibbons P.C. He was a partner in that firm for more than 20 years, specializing in debtor-creditor matters, corporate business reorganizations, and corporate litigation both in Federal and State Court proceedings. Throughout his tenure in private practice was always known for being practical, reasonable and fair. His legal adversaries always held him in high regard and considered him a true "Gentleman and a Scholar." He was appointed U.S. Bankruptcy Judge for the District of New Jersey on Feb. 2, 2001, and has presided in the Federal Courthouse in Newark, New Jersey since that time.

For these past 14 years Judge Steckroth has been acknowledged by his peers and the Bar as hard working, bright, fair and reasonable. His decisions have been recognized as thoughtful, well-reasoned and insightful. He is an active lecturer and panelist for, among others, the Association of Insolvency and Restructuring Advisors, the American Bankruptcy Institute, and the New Jersey Institute of Continuing Legal Education.

Thank you to Walter Greenhalgh for assistance with this article.

Bankruptcy Commission Recommends Chapter 11 Reforms

In response to criticism that parts of Chapter 11 have become outdated and are creating impediments to effective reorganization, he ABI established the Commission to Study the Reform of Chapter 11. Involving more than 150 bankruptcy professionals over a three-year period, the Commission approved and released its final report, comprising almost 400 pages and 241 recommendations, in December 2014.

A number of the report's recommendations seek to decrease what is perceived as the excessive control over the bankruptcy process by secured creditors, which has evolved over time since the Code was enacted in 1978. Some commenters note the commercial lending industry has long been at odds with proposed reforms, holding they would put recoveries at risk, raise the cost of credit and damage capital markets. However, many industry professionals assert reform will not hurt capital markets and will result in smaller but healthier entities, increased and earlier filings, and more successful restructurings with attendant benefits to stakeholders, communities and the economy.

Among the proposed changes: eliminating a key requirement for cram down; letting debtors seek confirmation without support from impaired creditors (thus incentivizing negotiation and discouraging tactical maneuvering such as manipulating voting classes); the creation of an "estate neutral" with power to examine fees, manage contested asset sales and handle other oversight in lieu of costlier examiners or trustees; extension of the deadline for debtors to keep or reject property leases; and elimination of some unfair windfalls where private stockholders are "over-shielded" by safe harbor laws to the detriment of other parties in interest.

It is estimated that it could be at least 2018 before any bills are ready for congressional action—the work has begun but much lies ahead. AIRA's Board of Directors and other members will study the Commission's report and recommendations and develop a response; later, it will prepare additional letters and reports as needed to legislators, Congressional committees, etc. If any member would like to participate in the process, please email gnewton@aira.org

Best wishes for the new year,

GRANT NEWTON, CIRA
AIRA Executive Director

AIRA | Association of Insolvency & Restructuring Advisors

31st Annual Bankruptcy & Restructuring Conference

JUNE 3-6, 2015
THE RITZ-CARLTON
PHILADELPHIA, PA

Program details and registration coming soon at www.aira.org

Program details for AIRA's 2015 Annual Conference in Philadelphia, June 3-6, will be completed and announced soon by the Planning Committee and Co-chairs Charles Persing, CIRA (Bederson LLP), Angela Shortall, CIRA (Protiviti Inc.), and Joel Waite (Young Conaway Stargatt & Taylor, LLP). Now is an excellent time to add your firm to the following list of generous sponsors that have confirmed support. For information about sponsorship opportunities, please contact the co-chairs or Cheryl Campbell (541) 858-1665 or ccampbell@aira.org

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Thank you for your generous support and helping to make the AIRA's 31st Annual Bankruptcy & Restructuring Conference a success. See you in Philadelphia!

AIRA Standards Provide Guidance for Distressed Valuations

DAVID BART, CIRA, CDBV
McGladrey LLP

The Association of Insolvency and Restructuring Advisors (AIRA) released new standards for distressed business valuation earlier this spring with an effective date of March 1, 2014.[1]

The Standards for Distressed Business Valuation should guide best practices for all valuations professionals, but apply directly to all AIRA members and certificate holders whenever they offer an opinion of value, including valuation engagements or other engagements in which valuation approaches and methods are used to develop an opinion or conclusion of value.

Required Applications of the Valuation Standards

Specifically, AIRA's members and certificate holders are required to follow these standards when developing an opinion of value regarding:

- Reorganization value
- Enterprise value
- Values of debt or equity in a plan of reorganization
- Value of assets in a sale
- Liquidation values
- Financial reporting values, i.e. fresh start accounting
- Value of tax attributes for future use
- Possible other topics, depending on the extent of the valuation opinion, including:
  - Value of capital structure
  - Value of payouts under a plan of reorganization
  - Collateral values
  - Best Interest Test
  - Solvency opinion in a fraudulent transfer matter
  - Equity cushion in adequate protection matters.

[1] See the AIRA's Standards For Distressed Business Valuation on the AIRA's website at https://www.aira.org/aira/standards.

The AIRA's valuation standards include assignment-specific exemptions where a professional is not required to follow the standards. Those exceptions include services to perform:

- Calculations
- Reconciliations
- Cash requirement computations
- Fairness opinions
- Damages
- Solvency opinions
- Internal use assignments
- Situations requiring use of different, proscribed methodology (e.g.. an ESOP valuation)
- AICPA attest engagements
- Financial advisory services that do not rise to the level of providing an opinion of value.

Growing Body of Regulatory and Legal Standards

The AIRA has joined a wide variety of organizations that have established basic business valuation standards in an attempt to provide guidance on generally accepted valuation theory and minimum reporting criteria. These organizations include:

- American Institute of Certified Public Accountants
- American Society of Appraisers
- The Appraisal Foundation
- The Institute of Business Appraisers
- National Association of Certified Valuation Analysts
- International Valuation Standards Committee.

The basic standards set forth by these organizations join a growing body of regulatory and legal standards. IRS Business Value Guidelines define appropriate valuation methods for taxable transactions. Both the Department of Labor and the IRS have established valuation methods for ESOPs. The SEC has a number of policies, practices and rulings that set valuation standards for publicly traded securities. Regulations and case law regarding the U.S. Bankruptcy Code, the Small Business Administration, and various state business corporation acts, divorce laws and insurance regulations also influence generally accepted valuation practices.

AIRA's valuation standards include several key elements common among the varying standards listed above that govern the practices valuation professionals must follow. These include:

- An independence requirement
- A prohibition on making fees contingent on the conclusion or appraisal value
- A requirement to explicitly state any limiting conditions
- The need to clearly state all assumptions and their impact on the outcome and interpretation of the valuation
- The full disclosure of all people participating in the valuation
- The identification of the professional responsible for the valuation report, including a signature certification of independence, the fee arrangements and other factors
- The identification of all information sources in order to allow replication of valuation computations and reports
- A requirement to follow generally accepted valuation approaches and methods.

AIRA's valuation standards also share certain key reporting requirements, including:

- Purpose and scope of the valuation engagement
- Standard of value and specific valuation date employed
- The specific interest being valued
- Identification of relevant state and federal laws that govern the entity being valued
- Scope of the procedures employed
- Nature and history of the business
- Historical financial information
- Financial analysis comparing the business' performance with industry trends
- Overview of the industry in which the business operates
- Impact of market conditions on the business
- Explanation of valuation procedures, approaches and methods used
- Reconciliation of the valuation opinion.

Finally, AIRA's valuation standards share roughly similar exceptions to those found in other standards, such as:

- Valuations performed as part of an attest engagement
- Internal use assignments when the preparer is not in public practice — i.e., private company valuations performed by employees for internal reporting purposes
- Economic damage calculations (lost profits, etc.) unless the calculations are part of an engagement to estimate of value
- Mechanical computations that do not rise to the level of a valuation and where no independent valuation approaches are used
- Litigation and jurisdictional exceptions
- Fairness opinions
- Solvency opinions.

AIRA's valuation standards offer guidance on how the valuation professional should proceed when valuation approaches are not possible due to a lack of relevant information. They also instruct the professional to follow the applicable authority if any part of the standards differs from published governmental, judicial or accounting authority.

What's Different About the AIRA's Valuation Standards?

Given this seemingly robust set of shared standards, what do the new AIRA valuation standards add when it comes to the valuation of distressed business interests? The answer is that the AIRA specifically identifies and addresses those issues that make the valuation of distressed interests different.

First, AIRA's valuation standards recognize that distress may not only be financial, but can also include operational, legal, regulatory and other factors. Second, they recognize that the specific nature of that distress and the legal context and intended purposes giving rise to the valuation may require significant adjustments to traditional valuation methodologies. Typical valuation adjustments may not be relevant in the case of a distressed business interest and can overstate the valuation. Among the adjustments and specific issues that the AIRA addresses are:

- Hindsight and subsequent events
- Fair value
- Ownership and control
- Valuation approaches and methods
- Valuation adjustments
- Discounts and premiums
- Importance of market conditions
- Reorganization values and enterprise values
- Relevant illustrations of assumptions and limiting conditions
- Volatility or truncation of cash flows
- Risk adjusted discount rates

- Financing issues, including the how perceived risks will affect the ability secure financing and the impact of higher interest rates
- Excessive leverage
- The impact of significant changes to business strategy
- Liquidity constraints
- Uncertain probabilities of an operational or financial turnaround
- Periods with shrinking revenues or declining margins
- Asset divestitures
- Significant payouts to constituencies
- Minimum floor values for collateral
- Limited relevant market data (typically from healthy companies).

The AIRA's valuation standards also do away with many of the distinctions among engagement types followed by other organizations. Instead of defining differences among valuations, calculations and engagements in its standards, the AIRA states that it "considers the computation of value using valuation approaches and methods that require a member to apply professional judgment in the application of those approaches and methods to be a Valuation Engagement…..A Valuation Engagement under these Standards results in opinions regarding a conclusion of value."

Similarly, the AIRA has dispensed with the distinctions among various report types, opting instead to set minimum expectations for content and to require its members and certificate holders to use appropriate "professional judgment" in order to provide "sufficient information" to fit the circumstances.

As a result of this approach, the AIRA's standards are generally consistent and do not conflict with the standards from other organizations, but AIRA's standards offer considerably more guidance on matters pertaining to distressed situations and the legal environment they face.

Why Standards Matter

For attorneys, the evolution of a broad set of valuation standards with a largely shared set of practices, reporting requirements and exceptions offers an increased level of assurance that the work products on which they rely will provide sound information based on proven methodologies. For attorneys dealing with distressed business interests, the AIRA's valuation standards offers the further assurance that valuation work is properly tailored to the very different and challenging circumstances those situations present.

Challenges to financial experts are increasingly common and increasingly successful, so any attorney considering testimony by a valuation professional must consider whether that professional's qualifications, methodologies and work product can withstand thorough examination.

ABOUT THE AUTHOR

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Director | McGladrey LLP

David Bart has more than 25 years of experience assisting parties in interest and their counsel in financial consulting, bankruptcy and complex commercial litigation. He provides expert consulting and testimony in cases involving damages assessment, business operations, solvency analysis, fraudulent conveyance, business valuation, forensic accounting and financial investigation projects. David's expertise includes financial and economic analysis, investigative accounting, statistical analysis, and business valuation. He provides his clients with consulting services that have resulted in business and financial restructuring, reduced operating costs, identification of unprofitable business segments, and successful negotiation of credit support with vendors and lenders. David is a member of AIRA's Board of Directors and played a key role in developing AIRA's Standards for Distressed Business Valuation. He may be contacted at david.bart@mcgladrey.com

Federal rules of evidence state that a witness who is qualified as an expert by knowledge, skill, experience, training, or education may testify in the form of an opinion or otherwise if:

- The expert's scientific, technical, or other specialized knowledge will help the trier of fact to understand the evidence or to determine a fact in issue
- The testimony is based on sufficient facts or data
- The testimony is the product of reliable principles and methods
- The expert has reliably applied the principles and methods to the facts of the case.

Judges consider both the qualifications of experts and the methods and data used by those experts when deciding whether to allow their testimony. Three tests apply:

1. **The Frye Test:** The expert's methodology must be generally accepted in the field to which it applies. This requires a two-part analysis. First, the judge must decide if the witness is an expert in the field at issue. Second, the judge must decide if the evidence offered by that expert derives from a methodology generally accepted in that field.

   (Frye v. U.S., 293 F. 1013 (D.C. Cir. 1923))

2. **The Daubert Test:** Trial judges act as gatekeepers to exclude unreliable expert testimony using the following questions:

- Has a theory or technique has been tested for reliability or is it simply subjective and conclusory?
- Has the technique or theory has been subject to peer review and publication?

- What is the technique or theory's known or potential rate of error?
- Do standards and controls exist concerning work with the technique or theory and are they maintained?
- Has the technique or theory has been generally accepted in the scientific community.

(Daubert v. Merrell Dow Pharm., Inc., 509 U.S. 579 (1993))

3. **The Kumho Tire Test:** The Frye and Daubert tests also apply to technical and other specialized knowledge.

   (Kumho Tire Co. v. Carmichael, 526 U.S. 137 (1999))

For financial experts, Daubert challenges are by far the most common, and the most dangerous. Daubert challenges to financial experts are increasing. Consider the following findings from "Daubert Challenges to Financial Experts 2012."[2]

- Daubert challenges to financial expert witnesses increased almost four-fold between 2000 and 2012, with 192 challenges in 2012. Results in 2013 showed a decrease from 2012 to 175 challenges.
- Testimony excluded in whole or in part due to these challenges has more than tripled in the past 14 years to 86 exclusions in 2012 and 71 in 2013.
- Accountants and economists are the most frequently challenged financial experts, each accounting for 24% of challenges. Appraisers accounted for 19% of challenges in 2013, nearly double their 14 year average of 11%; and, they were successfully challenged almost 45% of the time.

Now consider the most common reasons for Daubert challenges to financial experts. Lack of reliability is the top reason cited for successful exclusion. Over the past 14 years, lack of reliability accounted for 43% of full or partial exclusions. Lack of relevance accounted for another 23% of exclusions. In 171 out of 718 challenge exclusions, or 24% of the time, multiple reasons were cited. **Exhibit 1** lists a number of common Daubert challenges and reasons for the successful exclusion of experts.[3]

Contemplate these lists of reasons for challenges and exclusions, by considering the evolution of similar sets of valuation standards among AIRA and its peer organizations—and AIRA's specific standards for the valuation of distressed businesses. The need for better establishing guidelines for best practices has never been greater. These standards:

- Set a robust set of qualifications for professionals performing valuation work
- Establish clear scopes defining the boundaries of valuation engagements

Exhibit 1: Daubert Challenges to Financial Experts

Common Daubert Challenges

- Arbitrary / unreliable methodologies
- Lack of detail/supporting data
- Failure to include/exclude data / failure to test data
- Insufficient evidence to support opinion
- Irrelevant testimony
- Ignoring market factors
- Ignoring prior financials
- Failure to include variables
- Improper use of averages
- Inappropriate comparables
- Inappropriate growth rates
- Doubtful conclusions/errors
- Unreliable methodology/ incomplete statistical analysis

Some Reasons for Successful Exclusions

Reliability of:

Facts / Data
Methods
Testability
Peer Review
Error rate
General acceptance
Relevance

Qualifications:

Education
Knowledge
Skill
Training
Experience

[2] See Daubert Challenges to Financial Experts 2013, PricewaterhouseCoopers.

[3] Ibid.

- Define accepted methodologies for the steps, methods, analysis and conclusions of valuation engagements
- Define the appropriate use of data
- Set guidelines for adjustments
- Define analytical issues professionals should consider
- Provide rules concerning conclusions, assumptions and limiting considerations
- Provide standards for written reports.

The right degree, certifications and experience may once have been enough to withstand most challenges, but no more. Judges are looking well beyond qualifications to also consider methodologies, data and other issues. In the event that an expert witness is challenged, be prepared to address the following:

- Did the expert use generally accepted methods? Did the expert adhere to valuation standards such as those promulgated by AIRA, and did the work reflect the application of fundamental economic principles and established valuation theory?
- Is the expert following best practices? Since the AIRA and other valuation standards are based on widely vetted best practices, they provide a roadmap to evaluate the work, whether or not they are binding (i.e. even if they are limited by exceptions for litigation, fairness opinions, solvency opinions, etc.).
- Is the expert's approach consistent with promulgated standards, professional and academic literature? Since AIRA and other valuation standards are based on the best thinking concerning valuation practices from through the business and academic communities, they can provide solid support to answer this question.
- Does the witness have the proper professional credentials and degrees? In addition to the appropriate academic credentials, professional training and experience, designations such as CDBV, CIRA, ASA, ABV, CBA, CVA and CPA are a valuable indicator of professional background and training in accepted methodologies.
- Is the expert independent and objective and has the data used been tested and verified? AIRA and other valuation standards all have independence requirements and an expectation that the data has been tested and verified.

One more tip for dealing with challenges. Be careful when using technical financial terminology. For example, sometimes the same terms have different meanings when used by real property and business valuations. Be sure the expert conveys information clearly and in language accessible to the audience, i.e. the court.

Given the alignment of AIRA and other valuation standards with the issues most commonly raised in Daubert challenges, these standards should not only help assure financial advisors and attorneys of a solid work product, but also that the product and the expert behind it is likely to withstand a challenge.

FEATURE ARTICLE

Challenging Lender Liens on Copyrights: Opportunities for Debtors and Unsecured Creditors

MARK B. JOACHIM, PAUL M. FAKLER AND MANUEL G. ARREAZA
Arent Fox LLP

Copyrights represent a large portion of assets in the publishing, media, and other industries. In the restructuring context, disputes over ownership, priority, and valuation of copyrights held by companies in these industries can have a tremendous impact. The Copyright Act, regulations of the Copyright Office, and the *Peregrine* line of cases in the Ninth Circuit – not controlling but as yet unchallenged in other circuits – establish rules for the perfection of liens in registered copyrights and the proceeds, inventory, revenues, and other products derived from such copyrights. Lenders who record their liens in registered copyrights with the U.S. Copyright Office may be unperfected by failure to comply with these rules. Moreover, even properly recorded liens may be subject to avoidance as preferences if filed within the 90-day statutory period prior to a company's bankruptcy filing. Lenders who do not toe the line risk substantial reductions in their collateral pools and recoveries. By the same token, these rules create significant opportunities for debtors and unsecured creditors to realize value.

The Cengage bankruptcy case, the largest and perhaps most complex bankruptcy case filed in 2013, presents a useful illustration of the potentially enormous impact of disputes over perfection[1] of copyrights. This article discusses the lines of attack available to debtors and unsecured creditors and provides a summary of the disputed copyright issues in *Cengage*.

Perfecting Liens on Copyrights and Proceeds

Some lenders may be surprised to learn that U.C.C. filings are insufficient to perfect liens in registered copyrights. To perfect security interests in a registered copyright, the liens must be recorded pursuant to Section 205 of the Copyright Act.[2] The recordation and priority provisions of Section 205 preempt state law on these matters. In fact, a security interest in a registered copyright can *only* be perfected by recordation in the U.S. Copyright Office. *See In re Peregrine Entertainment Ltd.*, 116 B.R. 194, 199 (C.D. Cal. 1990) (holding that "[r]ecording in the U.S. Copyright Office, rather than filing a financing statement under Article Nine, is the proper method for perfecting a security interest in a copyright," and bank that failed to file security interests with the Copyright Office was unperfected in debtor's copyrights as of the petition date). The District Court's decision in *Peregrine* is the leading case on the issue of recordation of security interests in copyrights and was expressly adopted by the Ninth Circuit Court of Appeals.[3] *See In re World Auxiliary Power Company*, 303 F.3d 1120, 1130 (9th Cir. 2002) ("*Peregrine's* holding applies to registered copyrights, and we adopt it.").

Assets directly derived from exercise of copyrights, such as sales revenue from copies of copyrighted works, may also be subject to Section 205. Under the *Peregrine* line of cases, in order to perfect a lien in the proceeds, revenues, inventory, or other products[4] of a registered copyright, a creditor must record the security interest with the Copyright Office. *See Peregrine*, 116 B.R. at 196 & n.20 (holding that agreements creating a security interest in the receivables generated by a copyright must also be recorded in the Copyright Office because "a copyright entitles the holder to receive all income derived from the display of the creative work.") (*citing* 17 U.S.C. § 106); *In re Avalon Software, Inc.*, 209 B.R. 517, 523 (Bankr. D. Ariz. 1997) (holding that failure to record security interest with Copyright Office rendered lien unperfected with respect to copyrights as well as inventory and revenues from exercise of affected copyrights). In this view, a secured creditor must record liens on any copyrights with the Copyright Office *and explicitly reference* liens on proceeds derived from those copyrights – regardless of whether those liens are already recorded as collateral under state law. As discussed below, some practitioners oppose this theory on the ground that perfection in assets derived in part from copyrights is governed by U.C.C., not the Copyright Act.

Completeness Requirement for Copyrights Recordations

Security interests in copyrights may be invalid if the recorded documents and attachments fail to specifically identify the works

[1] Full disclosure: Arent Fox LLP represented the Official Committee of Unsecured Creditors in the Cengage bankruptcy proceedings.

[2] Under the Copyright Act, a "transfer" includes any "mortgage" or "hypothecation of a copyright," whether "in whole or in part" and "by any means of conveyance or by operation of law." 17 U.S.C. §§ 101, 201(d)(1). A creditor's security interest in a copyright, essentially a mortgage on that copyright, is a "transfer" within the meaning of these provisions subject to Section 205's recordation scheme. *See, e.g., In re Peregrine Entm't, Ltd.*, 116 B.R. 194, 199 (C.D. Cal. 1990).

[3] The opinion was written by Judge Kozinski of the Ninth Circuit Court of Appeals (now Chief Judge of that Court), sitting in the U.S. District Court for the Central District of California by designation. Judge Kozinski is an influential jurist on copyright issues who has authored several seminal decisions in various areas of copyright law for the Ninth Circuit. The U.S. Congress has rejected several attempts by critics of *Peregrine* and other rulings to legislatively overrule the decision. While the authors have not found decisions disagreeing with *Peregrine* or its progeny, *Peregrine* is not controlling precedent in other jurisdictions.

[4] For brevity, this article refers only to "proceeds" of copyrights where appropriate.

to which they pertain. 17 U.S.C. § 205(c). Creditors that fail to identify the specific copyrights at issue by, for example, indicating the title or registration number of the copyright, have not provided "constructive notice" of their interests under the Copyright Act and may lose out to later-filing creditors. *See* 17 U.S.C. § 205(c)-(d); *In re World Auxiliary Power Co.*, 303 F.3d 1120, 1125-26 (9th Cir. 2002). In addition, Copyright Office regulations require that "[t]o be recordable, the document must be complete by its own terms." 37 CFR § 201.4(c)(2). A document will not be recorded if it "contains a reference to any schedule, appendix, exhibit, addendum, or other material as being attached to the document or made a part of it" unless (1) the referenced material "is also submitted for recordation with the document" or (2) "the reference [to the missing material] is deleted by the parties to the document." 37 CFR § 201.4(c)(2)(i). This "completeness requirement" means that a recordation merely referencing an existing security interest in copyrights or the other documents creating that interest may be insufficient to perfect that interest. The Copyright Office does not screen recordings for compliance with applicable law and regulations.[5]

"Short-form transfers" omitting commercial terms irrelevant to the chain of title are permitted in some instances. 37 CFR § 201.4(c)(2)(iii) (a document that "merely identifies or incorporates by reference another document, or certain terms of another document" will not run afoul of the completeness requirement for that reason alone). However, a short form transfer that references an unrecorded document as *governing* the terms necessary to provide full notice of chain of title may not comply with the completeness requirement.

Security Interests in Recorded Copyrights in Bankruptcy

The basics of preference and avoidance actions are familiar to lenders and bankruptcy professionals. To avoid a preference, a debtor must show that the transfer (1) benefitted a creditor; (2) was on account of an antecedent debt; (3) was made while the debtor was insolvent; (4) was made within 90 days before the bankruptcy; and (5) enabled the creditor to receive a larger share of the estate than if the transfer had not been made. 11 U.S.C. § 547(b); *see also In re Flanagan*, 503 F.3d 171, 180 (2d Cir. 2007). The debtor is presumed insolvent during the 90 days prior to the petition for bankruptcy. *Id.* at 180; *see also* 11 U.S.C. § 547(f) and (g).

Recording a security interest generally meets the Bankruptcy Code's broad definition of a "transfer." *See* 11 U.S.C. § 101 (defining a transfer as "every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property, including retention of title as a security interest and foreclosure of the debtor's equity of redemption."). In most cases, the security interest is taken on account of antecedent debt, yields a clear benefit to the creditor, and, if not avoided, will enable the secured creditor to recover a greater amount in the bankruptcy case than if the security interest had not been taken. *See, e.g., In re AEG Acquisition Corp.*, 161 B.R. 50, 57 (B.A.P. 9th Cir. 1993) (affirming bankruptcy court's finding that the creditor got more as a result of the transfers than if the transfers had not been made because it was a secured creditor as a result of the transfer) (*rev'd on other grounds* by *In re World Auxiliary Power Co.*, 303 F.3d 1120 (9th Cir. 2002)).

The remaining elements of section 547(b) are met if the transfer is made from an insolvent debtor within 90 days before the debtor files a bankruptcy petition. A "transfer" is made "at the time such transfer is perfected" if not perfected within 30 days that the transfer takes effect. 11 U.S.C. § 547(e)(2)(A). If not perfected within that time, the date of the transfer is the date of perfection or, in some cases, the petition date. *Id.* § 547(e)(2)(B)-(C); *see also in re Moorhouse*, 487 B.R. 151, 153 (Bankr. W.D.N.Y. 2013). Where a secured creditor perfected a security interest in copyrights – as determined under the Copyright Act – by recordation with the Copyright Office more than 30 days after taking the security interest and within the preference period of 90 days before the petition date, the debtor may have a prima facie claim to avoid a prepetition transfer of the debtor's assets. Of course, any preference claim will be subject to the statutory defenses of section 547(c) (protecting transfers that, among other exceptions, were made for new value or in the ordinary course of business).

If a debtor successfully avoids a secured creditor's liens on copyrights under section 547, those liens will be preserved for the benefit of the debtor's estate. 11 U.S.C. § 551. The estate steps into the shoes of the avoided lienor, and acquires the same priority that the avoided lienor's lien had with respect to other creditors' liens. *See in re Kopel*, 232 B.R. 57, 70 (Bankr. E.D.N.Y. 1999) (*citing In re DeLancey*, 94 B.R. 311, 313 (Bankr. S.D.N.Y. 1988)). By

[5] *See Copyright Office Policy Decision*, Docket No. 92-1, 57 FR 27074-01, 1992 WL 132966 at 27074-5 ("Members of the public who submit documents for recordation cannot rely on the Copyright Office to screen their documents for even obvious errors in formal sufficiency. The public is therefore cautioned to review and scrutinize any document to assure its formal sufficiency before submitting it to the Copyright Office for recordation. The Copyright Office will record the document without examining it even for obvious errors, but recordation may be without legal effect unless the remitter has prepared the document in a way that satisfies applicable legal requirements.").

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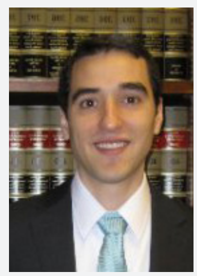

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successfully avoiding a first lien lender's lien on copyrights, the estate becomes a secured creditor with a security interest in those copyrights.[6]

What if other secured creditors have perfected liens in the same copyrights? Again, it appears that the Copyright Act, rather than the U.C.C., determines the priority between the estate (holding the avoided liens) and the other creditors holding properly perfected liens in the copyrights. *See* U.C.C. § 9104; *see also Peregrine*, 116 B.R. at 205. The Copyright Act establishes its own scheme for determining priority among conflicting transfers of interests in copyrights:

> As between two conflicting transfers, *the one executed first* prevails if it is recorded, in the manner required to give constructive notice under subsection (c), within one month after its execution in the United States or within two months after its execution outside the United States, or at any time before recordation in such manner of the later transfer. Otherwise, the later transfer prevails if recorded first in such manner, and if taken in good faith, for valuable consideration or on the basis of a binding promise to pay royalties, *and without notice of the earlier transfer.*

17 U.S.C. § 205(d) (emphasis added). Under this provision, a later-recorded security interest prevails over a faulty earlier recording *unless*, among other things, the holder had notice of the earlier recording. If a debtor successfully avoids senior liens on copyrights, junior creditors' liens are likely to remain subordinated to the avoided liens now held by the debtor's estate because the junior creditors had notice by intercreditor agreements or U.C.C. filings of the first lien interest. In these cases, the bankruptcy estate will recover first from these copyright assets and, in turn, make pro rata distributions to all creditors of the estate – a potentially significant boost for unsecured creditor recoveries.

Valuation

Valuation of an estate's intellectual property poses a significant challenge in any context. The challenge is far greater where a debtor successfully avoids liens (i) on copyrights on derivative works, while the secured creditor retains copyrights in the original works;[7] (ii) on proceeds, revenues, inventory, or other products of copyrights with values attributable at least in part to non-copyright assets.

Where different parties own the original and derivative copyrights, the divided copyrights present significant valuation problems. For example, if the new edition of a textbook contains new material registered as a derivative copyright, and that derivative copyright was avoided by a debtor while the original copyright remains with the lender, how does a bankruptcy court determine and apportion the value of the copyright and the proceeds? Little authority exists on these questions and every case is unique. The valuation process for these copyrights, and the proceeds and other products derived from the copyrights, may require special consultation andwitness testimony by industry and intellectual property valuation experts, plus a special dose of creativity by bankruptcy professionals.

Cengage

Cengage Learning, Inc. is a leading provider of content, teaching and learning solutions, software, and other educations services for both print and digital. *See* First Day Declaration, *In re Cengage Learning, Inc., et al.*, Case No. 13-44106, at ¶ 6 (July 2, 2014) [Docket No. 15]. The company is one of the largest publishers of course materials in U.S. higher education. *Id.* The company filed for chapter 11 protection on July 2, 2014 in the United States Bankruptcy Court for the Eastern District of New York. *Id.* at ¶¶ 9-14.

Nearly all of Cengage's revenues of almost $2 billion per year were derived from the exercise of its approximately 60,000 registered copyrights. Cengage's copyrights were listed among collateral securing several layers of debt, evidenced by a First Lien Credit Agreement, First and Second Lien Note Indentures, and ancillary documents. In the First Day Declaration, the company disclosed that two pools of 1,500 and 14,000 of these copyrights, respectively, could be available as a potential source of recovery for unsecured creditors. First Day Declaration at ¶ 25-27. The validity of the lenders' liens on these copyrights became a critical issue in the case.

The Official Committee of Unsecured Creditors investigated the matter and concluded that potentially all or nearly all of the lenders' liens on copyrights (and the proceeds thereof) were invalid under the Copyright Act and regulations, avoidable for the benefit of the estate, and available as a source of recovery for unsecured creditors (who were anticipated to receive marginal recoveries, if any, under the Debtors' initial proposed plan of reorganization).

The Committee ultimately persuaded the Debtors to pursue certain claims against the first lien lenders in an adversary proceeding in the bankruptcy case. However, the Debtors' reluctance to bring other claims led the Committee to intervene in the proceeding. The Debtors also sided with their secured lenders with respect to some claims. In addition, the Committee proposed a process to determine the value of any invalidated copyrights, including copyrights in derivative works intertwined with original copyrights still held by the Debtors. The claims and arguments concerning liens on copyrights, summarized in part below, were hotly debated both in court and in an extensive mediation process.

Preference Claims and Priority

First, the Committee argued that the Debtors could avoid the secured creditors' liens on the copyrights as preferences under § 547. All of the secured creditors recorded their liens on the 1,500 copyrights within the 90-day preference period, and the first lien lenders also recorded their liens on the 14,000 copyrights within that period. The recordation dates, well over 30 days after the grant of security interests, were the relevant transfer dates under § 547(b). Upon avoidance of these liens, the Committee argued, the Debtor's estate would step into the shoes of the first lien lenders with respect to the perfected liens in both pools of copyrights

6 Notably, the estate inherits the secured lenders' property rights but not contractual rights or obligations with respect to those property rights, such as intercreditor obligations containing subordination provisions with respect to junior secured debt.

7 A derivative work is based on a preexisting work that has been "recast, transformed, or adapted." 17 U.S.C. § 101. Its copyright is independent of the original copyright, but limited to the derivative work author's new original content. See 17 U.S.C. § 103. As a result, a derivative work cannot be lawfully exploited without the permission of both the derivative work copyright owner and the copyright owner of all preexisting content incorporated within the derivative work.

pursuant to Section 551 of the Bankruptcy Code, for the benefit of the unsecured creditors.

What about the competing liens of other secured creditors who properly recorded their liens on copyrights outside of the preference period? The Committee argued that the avoided liens held by the estate would have priority under Section 205 of the Copyright Act because those creditors, as parties to an intercreditor agreement with the first lien lenders explicitly referencing those liens and pursuant to the lenders' U.C.C. filings, had notice of the earlier transfers (*i.e.*, the security interests) and would not be entitled to priority over the estate. 17 U.S.C. § 205(d). The Committee also noted that the Debtors were not bound by any subordination or priority relationships set out in intercreditor agreements to which Cengage was not a party and that were, in any event, preempted by Section 205 of the Copyright Act.

The lenders responded in several ways. They asserted numerous claims and defenses, including the statutory preference defenses under section 547 (ordinary course of business, contemporaneous exchange) and claims alleging wrongdoing by the Debtors with respect to perfection of the liens on copyrights (unjust enrichment, unclean hands, and estoppel). The lenders also argued that because the other creditors had notice of the first lien lenders' liens, the Debtors could not wield the avoided claims to obtain a priority position. Under Bankruptcy Code §§ 547(e)(1)(B) and (e)(2)(B) and Copyright Act § 205(d), the first lien lenders' liens on the copyrights were arguably perfected before the preference period, when U.C.C. statements were filed evidencing those liens and providing notice to all creditors of the scope of the parties' liens. Thus, the lenders argued, no actual or hypothetical creditor existed that could acquire an interest superior to that of the first lien lenders.

Completeness

Second, the Committee challenged all of the lenders' liens in the copyrights on the grounds that the lenders' recordations failed to meet the completeness requirement of 37 CFR § 201.4(c)(2). The documents recorded by the lenders with the Copyright Office were Short Form Intellectual Property Security Agreements ("Short Form IPSAs"), referencing both the Credit Agreement and Long Form Intellectual Property Security Agreements. The Committee argued that the Short Form IPSAs were insufficient to determine the fundamental scope of the lenders' security interests because they referenced but failed to include the documents governing the meaning of relevant terms, the scope of the granted security interests, and the lenders' rights and remedies in the collateral.

Among other arguments, the lenders responded that the Short Form IPSA filings were sufficient because: (i) Section 205(a) sets forth the sole requirements for a short form filing, and the lenders' filings easily met these requirements; (ii) the "completeness requirement" set forth in the Copyright Office's regulations is unauthorized or exceeds the authority granted by Congress under the Copyright Act; (iii) the short form filings provided adequate notice by providing that the first lien lenders received security interests in all right, title and interest in the registered copyrights; and (iv) the incorporation by reference of the Long Form IPSA and Credit Agreement in the short form filings was sufficient under the Copyright Act and regulations. *See Debtors' Response*, Case No. 13-44106-(ESS) (Dec. 9, 2013) [Docket No. 833]; [BNY Answer and Counterclaims (Nov. 6, 2013)].

Liens on Proceeds

Third, the Committee argued that the lenders had no perfected liens in inventory or revenues derived from the copyrights because none of the lenders' recordations with the Copyright Office referenced inventory or revenues. Under *Peregrine*, the Copyright Act, and the regulations enacted by the Copyright Office, the lenders' short form filings violated the completeness requirement and were insufficient to perfect liens on the copyrights, much less the proceeds thereof. The Committee argued that properly recording a lien on copyrights, with no reference to proceeds of the copyrights, does *not* inherently include such proceeds or result in perfection of liens on proceeds. In support, the Committee emphasized that Section 202 of the Copyright Act expressly provides that a transfer of copyright ownership does not, without additional specific agreement, transfer any property rights in any physical copies of the work. 17 U.S.C. § 202.

The lenders strongly disagreed with the premise that the perfection of liens in proceeds of the copyrights requires a filing with the Copyright Office and cannot be accomplished by a U.C.C. filing. According to the lenders, the Copyright Act does not preempt state law with respect to the proceeds and other products of copyrights. The lenders' security agreements assigned to the lenders all right, title or interest in the copyrights, necessarily including the rights to the proceeds. The lenders argued that those U.C.C. filings were sufficient to perfect those interests and to put other creditors on notice of these interests.

Conclusion

The Cengage bankruptcy case unexpectedly triggered disputes on complex issues of first impression at the intersection of the Bankruptcy Code, the Copyright Act, and state common law. The Bankruptcy Court ultimately did not rule on these issues. Despite (or due to) the absence of compelling authority, the parties reached a resolution as part of a global settlement, and the Court confirmed a consensual plan in March 2014. The terms of the settlement and the final plan distributions – in particular, the substantially increased recoveries to unsecured creditors – suggest that the parties assigned a non-trivial value to the debtor's copyright claims. They are likely to recur in future bankruptcy cases involving significant copyright assets.

Secured lenders would be prudent to ensure that their liens on copyrights and the proceeds, revenues, inventory, and other products of such copyrights are properly perfected with the Copyright Office. These recordations should specifically identify the copyrights and collateral and provide adequate notice of the scope of the liens. Before stipulating to the validity and scope of secured lenders' liens on copyrights and proceeds and the value of that collateral, debtors and unsecured creditors in bankruptcy cases should consider consulting with valuation and copyright experts and investigating – and if appropriate, challenging – secured lenders' liens on copyrights.

For a Self Study Course related to this topic, see: "IP Licenses in Bankruptcy" available at www.aira.org

FEATURE ARTICLE

Is Higher Education Learning Anything? The Dangers to U.S. Institutions of Higher Education from Disruptive Challenges in the 21st Century

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Based on a paper presented at AIRA's 30th Annual Conference in Denver, Colorado, June 5, 2014, this article will attempt to shed light on the disruptive forces battering institutions of higher education in the U.S., with special emphasis on those that will most likely result in institutional insolvency and/or industry restructuring.[1] The scope of this article does not encompass legal analysis on past or present bankruptcies.

Introduction

This is a topic of paramount importance to our nation because it addresses challenges to one of the most significant contributors to the advancement of the United States for the past 478 years since the founding of Harvard University in 1636. First some disclaimers: (a) the author graduated from Stanford Law School without taking a single course in bankruptcy, but he has spent much of his career helping to restructure and put institutions of higher education on a sustainable course; (b) there is no original research in this material; it is all based on existing industry literature and personal conversations and observations; (c) the article includes quotes from experts who were courageous enough to question and challenge the status quo in one of the 'sacred cow' industries of our country; and (d) the article includes a number of statistics which readers are welcome to verify and interpret based on informed and prudent judgment.

There is much that is negative in this material, and yet there are many positive developments in higher education. However, since this material is presented to advisors of distressed entities, it is focused on trends and factors leading toward distress and ways in which bankruptcy and restructuring services will likely be required. The hope in sharing this information is that those experts who are best equipped to provide counsel and lead effective intervention will seek out and help institutions of higher learning to realistically face the environment and restructure themselves to survive and thrive in the 21st Century.[1]

Institutions of higher education do not often think of themselves as needing turnaround and restructuring services, but it is a growing phenomenon that such institutions are increasingly insolvent, and even if it is not time for many to declare bankruptcy, some are precariously close or are already there, but not admitting it. Americans tend to think of higher education as a fundamental part of the fabric of society—it is always there; it is non-profit and thus not susceptible to the external forces buffeting every other industry; infused with brand loyalty that blinds administrations, faculty, alumni, and boards. It is often considered too important to fail; yet that is merely a denial of reality—especially in the 21st Century. Just because it has been a favored industry does not mean it is invulnerable to the disruptive forces in our world.

To lay a groundwork of understanding as to the state of much of the higher education industry, two recent articles from Inside Higher Ed[2] (June 2, 2014) reflect prevalent signs of advancing distress:

- **Bryan College, Facing Enrollment Drop, Cuts Positions**. Bryan College, facing enrollment declines, is eliminating 20 of the 173 full-time employee positions… The college is also halting retirement contributions for a year, and imposing salary cuts on top administrators. *Inside Higher Ed*, June 2, 2014.
- **Moody's Downgrades Laureate's Credit Outlook**. Moody's Investor Service has downgraded the credit outlook for Laureate Education, Inc. to negative from stable, citing the global for-profit chain's increasingly leveraged position. Laureate, which is based in Baltimore and enrolls 800,000 students at 200 campuses around the world, has used debt (now $6 billion) to finance many of its acquisitions. *Inside Higher Ed*, June 2, 2014

Here are a few examples from the many recent headlines signaling distress in higher education:

"Business School, Disrupted"

"College Credentials by Condé Nast"

"The College-Cost Calamity: Many American Universities Are in Financial Trouble"

"More than 100 Colleges Fail Education Department's Test of Financial Strength."

"In Hard Times, Colleges Search for Ways to Trim the Faculty."

"The Ivory Tower: Crumbling from Within?"

"Colleges in Crisis as Enrollment Dips"

[1] To obtain a copy of the slide presentation go to https://aira.org/pdf/Is_Higher_Ed_Learning_Anything.pdf

[2] For a good resource book on this subject, *see* The Higher Education Bubble, by Glenn Harlan Reynolds (2012; ISBN 1594036659).

"Led By For-Profit Colleges, Student Loan Defaults At Highest Level In a Decade."

"Is a College Diploma Worth the Soaring Student Debt?"

"46 Percent of Federal Loans Paid to For-Profit Institutions Will Go Into Default."

"Private Student Loan Bankruptcy Bill...the 4th Attempt."

There are even more dire predictions about higher education:

> *The higher education revolution is coming. Just a few decades hence, half the colleges and universities in the United States will have disappeared, but schools like Harvard will have millions of students. In fifty years, if not much sooner, half of the roughly 4,500 colleges and universities now operating in the United States will have ceased to exist. The technology driving this change is already at work, and nothing can stop it. The future looks like this: Access to college-level education will be free for everyone; the residential college campus will become largely obsolete; tens of thousands of professors will lose their jobs; the bachelor's degree will become increasingly irrelevant; and ten years from now Harvard will enroll ten million students.*
>
> —The End of the University as We Know It. Nathan Harden in *The American Interest*, December 11, 2012.
>
> *In 15 years from now half of US universities may be in bankruptcy . . . . in the end I'm excited to see that happen. So pray for Harvard Business School if you wouldn't mind.*
>
> —Interview with Clayton Christensen of Harvard Business School, often touted as the #1 management thinker today, and co-author of *Disrupting Class: How Disruptive Innovation Will Change the Way the World Learns*, McGraw-Hill, 2008.

Summation of these headlines: The environment in which higher education operates today and the rules of engagement are changing rapidly and drastically, and those who fail to prepare and adapt are doomed to decline or failure.

Recent History and Current Status of U.S. Higher Education

Let us take a look at the current status and some challenges and forces created within and buffeting the industry.

Perception of Perseverance

Many surviving and thriving universities were begun in the Middle Ages—Oxford, Cambridge, Heidelberg, Vienna, Turin, St. Andrews, etc. Recognized as the first university, the University of Bologna was founded in 1088 and continues today. Partly due to this history, there is a sense of stability, a sense of place; stately buildings associated with campuses belie the risks that face many institutions.

Furthermore, we are not far from the Golden Age of higher education—a 60-year run of growth and amassing of resources since World War II. Our citizenry has considered a college degree as a ticket to upward mobility; there has been a surge of international students into American colleges; U.S. higher education has been generally free of competition, except among its own ranks, for students, faculty, reputation, and resources; the GI Bill has poured billions of dollars and millions of students into our universities; student loans have been available for the asking; the expanding governmental juggernaut has invested untold billions into research grants; and there has been a 10-fold increase in enrollment in 60 years. As we will see, many of these factors are declining or are at least being seriously questioned at the policy level.

Growth in Numbers

In early 2014, there were 4,599 degree-granting institutions and 2,870 are 4-year institutions. That is an increase of 42% in the number of institutions since 1980, to accommodate a 97% increase in the number of students over the same time period. (National Center for Education Statistics, U.S. Dept. of Education) Most of the student increases have been absorbed in the mega-universities, but most of the increase in number of institutions has been in small independent colleges—many of them inefficient and underfunded. Though enrollment in private institutions is much less than public institutions, private institutions produce almost half of all graduate degrees.

Increase in Cost

It is reported that tuition and fees have climbed 30% faster than health care costs and four times the rate of inflation since World War II. Tuition was 23% of median university income in 2001, and it increased to 38% by 2010. If recent trends continue, four years at a top-tier school will cost $330,000 in 2020 per Mark Taylor, Chairman, Religion Department at Columbia University, in *"Academic Bankruptcy,"* NYTimes, August 14, 2010.

Cost Pressures—Real and Artificial

Institutions of higher education are facing enormous cost pressures. Expectations of the students and parents have multiplied many-fold. Campuses feel the need to create a resort-like atmosphere with gourmet food, 4-star housing accommodations, climbing walls, state-of-the-art athletic facilities, and multiplied student services.

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New CIRAs

Congratulations to the following members who recently received the designation Certified Insolvency and Restructuring Advisor!

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CLUB 10

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Huron Consulting Group	30
Ernst & Young Capital Advisors, LLC	25
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Mesirow Financial Consulting, LLC	25
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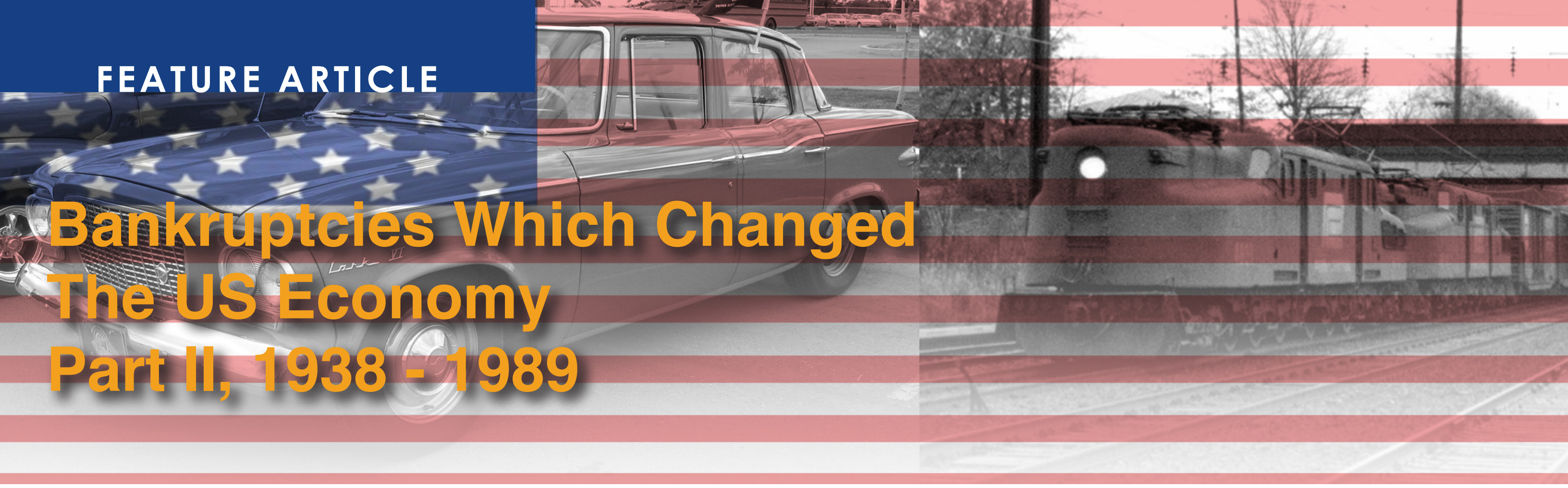
Protiviti Inc	20
Zolfo Cooper	19
Conway MacKenzie, Inc.	18
CohnReznick LLP	16
PricewaterhouseCoopers LLP	16
BDO Consulting LLP	14
Grant Thornton LLP	14
Berkeley Research Group, LLC	13
SOLIC Capital Advisors, LLC	13
Office of U.S. Trustee	11
Pension Benefit Guaranty Corporation	11



FEATURE ARTICLE

Bankruptcies Which Changed The US Economy Part II, 1938 - 1989

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This is the second article highlighting 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. (See AIRA Journal, 28:2; p. 26-28).

1938—McKesson-Robbins Bankruptcy Reorganization

During the Prohibition years, a con man named Philip Musica operated a "pharmaceutical company" which primarily produced high alcohol content hair tonics and cosmetics for which his main customers were bootleggers who converted them into alcoholic beverages. In 1925, Musica, who adopted several aliases in order to hide past fraud convictions, bought the larger McKesson & Robbins, a 90-year old pharmaceutical company. Musica greatly expanded the company's distribution system, putting them on a par with Rexall and Walgreens. By placing his brothers in key positions within the company, Musica plundered it via a phony inventory purchase scheme. The company's outside auditors were supplied with a forged Dunn & Bradstreet report on the fake vendor. When the embezzlement came to light, Musica was arrested and took his own life a short time later.[1]

The resulting investigations by the Securities Exchange Commission and the details revealed in the bankruptcy reorganization proved extremely embarrassing to the auditing profession. This led to action by the SEC and the American Institute of CPAs—greatly expanding the audit requirements for testing the system of internal control and an "iron rule" that physical inventory testing must be made where inventories are a material balance sheet asset.[2] McKesson-Robbins was reorganized in bankruptcy and is still in business today.

1966—Failure of Studebaker-Packard and the Inception of ERISA

In 1954 two struggling auto companies, Studebaker (based in South Bend, Indiana) and Packard (based in Detroit), merged to form Studebaker-Packard. Both had underfunded defined benefit pension plans. A defined benefit plan promises the employee a retirement benefit usually based on so many dollars per year times years of service. Such plans are usually funded over long periods of time and assume a certain level of investment earnings on plan assets to reduce required employer or employee contributions. Because such a plan makes a future promise to pay which is not immediately fully funded, there is always potential for default risk. This has historically been compounded by federal tax restrictions and disincentives to immediately fully fund a defined benefit pension plan. (In contrast, a defined contribution plan such as a 401(k) simply determines the amount of the current contribution and an employee withdraws the accumulated balance at retirement. Problems with defined benefit plans have become so great that almost all new retirement plans formed are of the defined contribution variety.)

The Packard division was the first to fail, closing in 1958 with inadequate funding of its pension plan, leaving some retired employees with reduced benefits and many active employees with no prospective pension benefits for their period of service with Packard.[3]

Studebaker was more diversified than Packard and for a while in the late 1950s it looked like the automobile division might succeed. In the fall of 1958 Studebaker introduced a new model—the Lark. One of only two domestic compact cars, it was a stunning success. "During the 1959 model year," a journalist reported, "more than 138,000 Larks moved into dealer showrooms, against a mere 56,000 Studebakers a year earlier," more than doubling the company's market share, and for the first time since the Packard merger, both the corporation and the automotive division made a profit. Studebaker's comeback ended abruptly in 1960 when GM, Ford and Chrysler introduced their own compacts. By the end of 1960, 11 domestically produced compact cars were

1 The Greatest Frauds of the (Last) Century, (Clikeman, 2003) http://www.newaccountantusa.com/newsFeat/wealthManagement/Clikeman_Greatest_Frauds.pdf

2 Address "The SEC Looks at Internal Control" (Kellogg, 1951) https://www.sec.gov/news/speech/1951/032751kellogg.pdf

3 "The Most Glorious Story of Failure in the Business": The Studebaker-Packard Corporation and the Origins of ERISA" JAMES A. WOOTEN (2001) Buffalo Law Review p. 716.

competing for sales, including the Chevrolet Corvair, the Ford Falcon and the Plymouth Valiant. (The Corvair later became Ralph Nader's number one target in his campaign for auto safety). In such a competitive environment, Studebaker was doomed by its poor dealer organization.[4]

By 1963, the handwriting was on the wall for the Studebaker automotive division and union officials became alarmed at the possibility of a termination and default in the division's defined benefit pension plan. In December 1963, Studebaker announced it would shut down the plant in South Bend; when the plant closed, the liability of the Studebaker pension plan exceeded its assets by $15 million. The shortfall made it obvious that the plan would default. The United Auto Workers could do little to change the lot of Studebaker employees, but the shutdown provided an opportunity to get policymakers to seriously consider a proposal for federal insurance to guarantee private defined benefit pension plans.[5] (In fact, Prof. John Wooten argues that the UAW made many policy decisions over the years to forgo protections for the Studebaker plan such as faster funding and stronger vesting, in order to obtain higher potential pension payouts and incentivize older workers to retire thus creating job security for younger workers).[6] The shutdown and loss of pension benefits created a national scandal and stirred Indiana Senator Vance Hartke and his staff to work with union officials to prepare federal pension insurance legislation. [7]

It took 10 years to pass the Employee Retirement Income and Security Act of 1974 (ERISA) but when it arrived, it was massive: 200 pages of legislation and legislative history amending many Internal Revenue Code sections and adding many sections to Title 29 on Labor. The law included provisions on: maximum vesting standards, maximum years of service and age before participation is allowed, disclosure of a plan's financial statements to participants and the government, audit requirements, prohibition of certain insider transactions, rules on funding defined benefit pension plans, a federal insurance fund known as the Pension Benefit Guaranty Corporation, and many other pension plan provisions. Besides addressing pension plans, ERISA contains rules regarding many other types of employee benefit plans such as health care and life insurance. The legislation contained many arcane rules and definitions which practitioners are still struggling with 40 years later. Unfortunately, the problems with tax restrictions and disincentives to more adequately fund defined benefit pension plans still continue since the Congress and Executive view them as a large "tax expenditure" and have carefully restricted them. The future of the Pension Benefit Guaranty Corporation itself is in doubt. A 2013 Government Accounting Office report states:

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> As a result of current and anticipated financial assistance, the present value of PBGC's liability for plans that are insolvent or expected to become insolvent within 10 years increased from $1.8 to $7.0 billion between fiscal years 2008 and 2012. Yet PBGC's multiemployer insurance fund only had $1.8 billion in total assets in 2012. PBGC officials said that financial assistance to these plans would likely exhaust the fund in or about 2023.[8]

1970—Penn Central Bankruptcy

Both the Pennsylvania Railroad Company and the New York Central Railroad Company had long histories starting in the early days of railroads. Pennsylvania Railroad was founded in 1846, eventually controlling 11,000 miles of track throughout the Northeast and the nation. The New York Central Railroad was founded in 1853 and stretched from Pennsylvania to as far as Ottawa, Canada. The companies were financed and run by well-known capitalists like J.P. Morgan and Cornelius Vanderbilt, who manipulated prices and transportation to freeze out competitors and consolidate their control. Both companies were highly complex, controlling land and real estate, transportation routes of many kinds, and commodities like coal and steel. The Penn Central also incorporated the New York, New Haven, and Hartford Railroad, a fiscally unsound railroad that the Interstate Commerce Commission required the new company to acquire and support. Although both railroads were failing as a result of competition with autos and trucking, and economics of short haul transportation of persons and goods, the New York Central and Pennsylvania were merged in 1968 to form the Penn Central. The ambitious conglomerate collapsed into bankruptcy two years later.

The Penn Central's collapse was the biggest business failure in American history at that time. In their book The Wreck of the Penn Central, Joseph Daughen and Peter Binzen claim that 100,000 creditors and 118,000 stockholders were affected by the 1970 bankruptcy.[9] Congress stepped in and formed Amtrak, a government owned "for-profit" corporation, to fill the vacuum for passenger travel. Penn Central freight operations were partially

4 "The Most Glorious Story of Failure in the Business": The Studebaker-Packard Corporation and the Origins of ERISA" JAMES A. WOOTEN (2001) Buffalo Law Review p. 716.

5 Ibid, p. 726.

6 Ibid, p. 695.

7 Ibid, p. 726.

8 Multiemployer Plans and PBGC Face Urgent Challenges, GAO (2013), http://www.gao.gov/assets/660/652687.pdf

9 Penn Central Transportation Company (Harvard Business School, Baker Library); http://www.library.hbs.edu/hc/lehman/company.html?company=penn_central_transportation_company

continued for six years until they were merged with other troubled eastern rail lines into Conrail, which struggled along for a number of years until it achieved profitability and was sold to the private sector in 1987.[10]

1975—Bailout of New York City

In 1975 after years of deficits, the growing fiscal crisis of New York City came to a head. The nation's largest city had literally run out of money and could not pay for normal operating expenses and default on its debt loomed. At the time, New York City and its subdivisions had $14 billion of debt outstanding of which almost $6 billion was short-term. The city admitted to an operating deficit of at least $600 million, although honest accounting techniques put it at more like $2.2 billion and the city found itself shut out from credit markets. The accumulation of short-term debt resulted from the city running chronic budget deficits from as early as 1961. Because of the city's poor budgetary and accounting practices, it is difficult to fix the date precisely. New York ran up these deficits even though a state law required political subdivisions to run balanced budgets. Despite the requirement, the city used obsolete and confusing budgeting and accounting systems that included such financial gimmicks as:

- Overly optimistic forecasts of revenues
- Heavy use of revenue anticipation notes, including notes for revenues that did not materialize
- Underfunding of pensions
- Use of funds raised for capital expenditures for operating costs
- Appropriation of illusory fund balances, meaning that special fund revenues were overestimated and used to balance the budget

Many looked to the State of New York and the federal government to rescue the City; first, when the city ran out of money in mid-April the state advanced revenue sharing funds to the city, and next, when the state created the Municipal Assistance Corporation (MAC). The MAC was an independent corporation authorized to sell bonds (referred to as "Big MACs") at rates up to 11% to meet the borrowing needs of the city. As part of the creation of MAC, the state passed legislation that converted the city's sales and stock transfer taxes into state taxes. These taxes were then used as security for the MAC bonds without ever passing through to the city. Besides creating MAC, the state also advanced additional funds to the city. The state prepaid state aid that the city was scheduled to get during the fiscal year, in an attempt to keep the city afloat. New York City, however, continued to deny the seriousness of the problem. Efforts to cut costs including layoffs were very minor but still resulted in significant labor unrest. The city continued to change plans and borrowing needs on a frequent basis, further eroding the market's already limited confidence inthe city's ability to handle their own financial affairs. The admitted deficit continued to grow, hitting $750 million.

At first President Ford rejected the notion of the federal government bailing out New York City. Subsequently, he bowed to mounting pressure and agreed to federal legislation aiding the City. In November of 1975 federal legislation extending up to $2.3 billion of short-term loans to the city was passed. Federal involvement was motivated by concerns over the impact of a bankruptcy on the city, state, other public agencies, and on the banking community. In addition, many small investors had bought New York City debt. The impending bankruptcy of New York had become an international issue. Both President Giscard of France and Chancellor Schmidt of West Germany told President Ford they were worried about the impact of a possible bankruptcy on the international banking system. The recent hike in oil prices had pushed the oil consuming countries into a harsh recession and the banking system had yet to recover. In addition, the finances of the State of New York were so intertwined with the City of New York that a municipal bankruptcy could have meant a state bankruptcy as well.

The City's return to financial health was a long and bumpy path, but the next two elected Mayors, Abraham Beame and Ed Koch, had substantial financial backgrounds. The city cut employment by 20 percent and work rules were loosened. The wages of city employees were reduced and eventual raises were held below the level of inflation. By 1977-78, the city had no short-term debt. As part of its obligation imposed by the federal government, the state assumed the full cost of financing the city university system and a portion of welfare and court systems. The Securities Exchange Commission (SEC) issued a special report in the aftermath of New York City's brush with bankruptcy. All of the players came in for their share of criticism. The report criticized the opinion of bond counsel for not being accurate and ignoring important information. For example, most of the notes sold by New York City did not have a true first lien on revenues despite bond counsel's opinion stating that they did. The major underwriters failed to fulfill their responsibilities to the investing public. Between October 1974 and March 1975, Merrill Lynch and six big banks underwrote $4 billion in New York City debt despite the clear financial problems that the city was having, including a 15-year string of budget deficits (they did however reduce their own positions in the city's debt). The SEC also criticized the tardiness of the bond rating agencies in downgrading the City's issuances.[11]

Although federal bailouts had occurred occasionally throughout the country's history, the 1975 New York bailout may have been the first example of "too big to fail"—setting the stage for a federal bailout of Chrysler Corporation in 1980 and the massive bailouts during subsequent financial crises.

1989—Charles Keating and Lincoln Savings & Loan

For decades, savings and loan associations had been staples of the American economic landscape—solid if unexciting institutions whose major business was making mortgage loans within their community. But in what became known as the S&L crisis of the

[10] CONRAIL: Government (Creation & Privatization of an American Railroad) World Bank, 1989 p. iii; http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2000/03/23/000178830_9810190215474/Rendered/PDF/multi_page.pdf

[11] Overview of New York City's Fiscal Crisis, California Research Bureau, California State Library (1995), http://www.library.ca.gov/crb/95/notes/v3n1.pdf

late 1980's, hundreds of thrifts suffered loan write offs, ending in a government takeover and bailout that ultimately cost taxpayers over $120 billion. One such failure, Lincoln Savings & Loan of Irvine, California, involved especially egregious looting and mismanagement which became bound up in national politics. In the 1960's, the government capped the interest rates that savings & loan associations could offer on their federally guaranteed accounts. During the high inflation days following the Arab oil embargo in the 1970s, interest rates soared to over 20%. In the early 1980's, savings & loans faced such difficulty in attracting money that the interest rate caps were removed. At the same time, some states relaxed the limits on the kinds of investments that S&Ls could make. A new breed of aggressive S&L's emerged, that attracted large pools of deposits by offering higher returns, and then used this cash to move into new lines of business, including junk bonds and real estate development. As the real estate boom came to an end, first in Texas and later elsewhere, losses started to pile up and by 1988 were estimated at $60 billion, overwhelming the funds available to the agency responsible for the federal deposit guarantee. In 1989, Congress created the Resolution Trust Corporation to take over the assets of shaky S&L's and dispose of them at fire-sale prices. Resolution Trust closed or reorganized 747 institutions holding assets of nearly $400 billion. It did so by seizing the assets of troubled savings and loans and then reselling them to bargain-seeking investors, usually other financial institutions. At the peak in early 1990 there were 350 failed savings and loan institutions under the agency's control.[12]

In 1984 Charles Keating, then a 61-year-old Phoenix real estate millionaire, bought Lincoln Savings & Loan of Irvine, California, for $51 million (double its net worth). With 26 branches, Lincoln made small profits on home loans but, under new state and federal rules, it could make riskier investments and Mr. Keating began pouring depositors' savings into real estate ventures, stocks, junk bonds and other high-yield instruments. In three years, Lincoln's assets soared to $3.9 billion from $1 billion, and Keating was using the business as his personal cash machine, taking $34 million for himself and his family and $1.3 million more for political contributions, prosecutors said.

The Federal Home Loan Bank Board, fearing wide collapses in a shaky industry, finally imposed a 10 percent limit on risky S&L investments. By 1987, its investigators found that Lincoln had $135 million in unreported losses and was more than $600 million over the risky investment ceiling. Soon the FBI, SEC and other agencies were moving in. Mr. Keating hired Alan Greenspan, soon to be chairman of the Federal Reserve, who compiled a report saying Lincoln's depositors faced "no foreseeable risk" and praising a "seasoned and expert" management.

Mr. Keating called on five senators who had been recipients of his campaign largess—Alan Cranston of California, Donald W. Riegle Jr. of Michigan, John Glenn of Ohio, and Dennis DeConcini and John McCain of Arizona—to pressure the regulators to relax their rules and kill the investigation. Edwin Gray, chairman of the Federal Home Loan Bank Board, resisted but was replaced by a chairman more sympathetic to Mr. Keating, and the board backed off, with disastrous results for depositors and investors.

Lincoln's holding company, American Continental, went bankrupt in 1989, and an insolvent Lincoln was seized by the government. Some 23,000 customers were left holding $250 million in worthless, uninsured holding company bonds and taxpayers paid $3.4 billion to cover Lincoln's insured losses. It was the largest of 1,043 S&L failures from 1986 to 1995, which together cost the savings and loan industry $29 billion and taxpayers $124 billion.[13]

As a result of the S&L crisis, the Federal Deposit Insurance Corporation Improvement Act (FDICIA) was created. This statute enacted needed reforms to the system of bank supervision and regulation and to federal deposit insurance. Much of the act was designed both to curb the incentives that deposit insurance gives to weakly capitalized insured banks to take excessive risks, and to limit the cost of failures to the FDIC. The primary purpose of the legislation was to provide the bank insurance fund with a $30 billion line of credit, but it also took an important step toward limiting the discretion exercised by bank examiners and supervisors to assess the condition of banks and bring enforcement actions against problem banks.[14]

Charles Keating was prosecuted and spent several years in prison. The "Keating Five"—all Democrats except Senator McCain—insisted they had done nothing improper. The Senate Ethics Committee concluded in 1991 that none had violated laws, but it said that Senators Cranston, DeConcini and Riegle had interfered with the bank board's inquiry and rebuked them, Mr. Cranston in the harshest terms. Senators Glenn and McCain were cleared, but were criticized for "poor judgment."[15]

Conclusion

Large bankruptcies will always send reverberations through the US economy, as the more recent and all too familiar Enron, WorldComm and Lehmann Brothers cases demonstrate. We will leave these latter cases for another day.

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

12 The New York Times, "Savings and Loan Associations"; http://topics.nytimes.com/top/reference/timestopics/subjects/s/savings_and_loan_associations/index.html

13 New York Times "Charles Keating, 90, Key Figure in '80s Savings and Loan Crisis, Dies" (2014) http://www.nytimes.com/2014/04/02/business/charles-keating-key-figure-in-the-1980s-savings-and-loan-crisis-dies-at-90.html

14 Before and After the FDICIA: A Look into Commercial Banking Risk Behavior and Profit, Lisa Birr, Illinois Wesleyan University, https://www.iwu.edu/economics/PPE09/lisa.pdf

15 New York Times "Charles Keating, 90, Key Figure in '80s Savings and Loan Crisis, Dies" (2014) http://www.nytimes.com/2014/04/02/business/charles-keating-key-figure-in-the-1980s-savings-and-loan-crisis-dies-at-90.html

FEATURE ARTICLE

Supreme Court Leaves Key Question on Extent of Bankruptcy Court Authority Unanswered for Now[1]

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In June, a unanimous Supreme Court issued the latest in a series of key rulings regarding the extent of a bankruptcy court's constitutional authority.[2] Notably, while the Court's *Executive Benefits* decision answered one important question arising out of its 2011 decision in *Stern v. Marshall*,[3]it also left the primary question that resulted in a split in the Circuit Courts of Appeals to be decided another day.

The Aftermath of *Stern v. Marshall*

In *Stern v. Marshall*, the Supreme Court addressed the scope of judicial authority conferred upon courts under the Constitution. Pursuant to Article III of the Constitution, justices of the Supreme Court, circuit judges, and district judges—all commonly referred to as "Article III judges"—receive lifetime appointments and protection against reduction in salary.[4] Congress created the bankruptcy courts pursuant to its power under Article I of the Constitution and Article I bankruptcy judges do not enjoy the tenure and salary protections afforded to Article III judges under the Constitution. The Supreme Court in Stern determined that the constitutional distinction between Article III and Article I courts creates a separation of powers issue that requires limitations on those matters on which bankruptcy judges may enter final orders.[5]

Specifically, the Court held in *Stern* that with the exception of certain "public rights,"[6] Congress cannot withdraw from adjudication by Article III judges any matter that would traditionally constitute a suit at common law. *Stern* involved a state law counter-claim designated by Congress under 28 U.S.C. § 157(b)(2)(C) as a "core" bankruptcy proceeding that bankruptcy courts had the power to finally adjudicate, but which the Supreme court held was outside the scope of the bankruptcy court's constitutional authority.[7] As a result, the Court held that although the federal statute permitted the bankruptcy judge to adjudicate the counter-claim, Article III of the Constitution did not. The Court left open, however, the question of whether a party could consent to a bankruptcy judge entering a final order on a matter that, absent such consent, would require final disposition by an Article III judge. In *Stern's* aftermath, a number of courts weighed in on that question, including, among others, the Sixth and Ninth Circuit Courts of Appeals, creating a circuit split on the issue.

As explained below, notwithstanding the Court's Executive Benefits decision, the issue that has generated the most uncertainty and debate still remains undecided.

The Circuit Split: Executive Benefits[8] and *Waldman v. Stone* [9]

The Ninth Circuit

The Ninth Circuit Court of Appeals, in *Executive Benefits*, held that a party may consent to a bankruptcy judge entering a final order on a matter that, absent consent, would require final adjudication by an Article III judge. The court noted that the concerns expressed in *Stern* regarding the differences between Article III and Article I courts involved primarily the protection of personal, rather than structural, interests. Moreover, citing concerns with the tactics of litigants who might delay in raising an objection to a final determination being made by a bankruptcy judge, the panel explained that a party should not be permitted to remain silent about its objection throughout the course of litigation, only to belatedly raise the concern if it loses. Based on these considerations, the Ninth Circuit held that a party may implicitly consent to a matter being decided by a non-Article III bankruptcy judge even though the judge would not have the authority to decide the matter without consent.

The Ninth Circuit also explained the procedure to be followed by bankruptcy courts when they lack constitutional authority to enter final orders on matters before them. The issue arises under 28 U.S.C.

1 This article is a slightly modified version of an article that first appeared in the July 31, 2014 *Westlaw Journal Bankruptcy*. It is reprinted here with permission from West Services, Inc.

2 *Executive Benefits Insurance Agency v. Arkison*, 573 U.S. __ (2014) ("*Executive Benefits*").

3 *Stern v. Marshall*, 564 U.S. ___; 131 S. Ct. 2594 (2011).

4 U.S. Const. art III, § 1.

5 Questions regarding the permissible constitutional extent of bankruptcy judges' authority are not new; they have complicated practice under 11 U.S.C. §§ 101-1532 (the "Bankruptcy Code") virtually since the time of its enactment in 1978. *See, e.g., Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982); and *Granfinanciera, S.A. v. Nordberg*, 492 U.S. 33 (1989).

6 Under "public rights" doctrine, non-Article III courts may resolve matters that historically could have been determined exclusively by executive or legislative branches of government. These include claims deriving from a federal regulatory scheme, or claims that by their nature must be resolved by a federal agency and are directly related to the agency's function. "Private rights," on the other hand, involve claims between private parties. In the context of bankruptcy, they include state law contract disputes and actions to augment the bankruptcy estate, as opposed to disputes related to the bankruptcy claims allowance process.

7 In general terms, "core" proceedings are matters that involve substantive bankruptcy rights or that only arise in the bankruptcy context. "Non-core" proceedings, on the other hand, are actions that do not arise due to the filing of a bankruptcy, but that may affect or be affected by the bankruptcy.

8 *Executive Benefits Insurance Agency v. Arkison (In re Bellingham Insurance Agency, Inc.)*, 702 F.3d 553 (9th Cir. 2012).

9 *Waldman v. Stone*, 698 F.3d 910 (6th Cir. 2012).

§ 157 pursuant to which Congress conferred authority upon the bankruptcy courts to enter final orders on all "core" matters arising under the Bankruptcy Code or arising in a case under the Bankruptcy Code, and to submit to the district court proposed findings of facts and conclusions of law on "non-core" matters otherwise related to a case under the Bankruptcy Code. The question presented to the Ninth Circuit was whether a bankruptcy court had the statutory authority under 28 U.S.C. § 157(c)(1) to submit proposed findings of fact and conclusions of law on matters identified in the statute as "core" but which, pursuant to the Supreme Court's holding in *Stern v. Marshall*, the court lacked constitutional authority to adjudicate through entry of a final order. In light of what some suggested was a "statutory gap," an argument could be made that bankruptcy judges lacked the power to consider such clams. After reviewing both Congress's intent in drafting the statute and the *Stern* decision, the Ninth Circuit held that, notwithstanding any statutory gap, bankruptcy courts have the authority to submit proposed findings of fact and conclusions of law with respect to this category of core claims.

The Sixth Circuit

Shortly before the Ninth Circuit's decision in *Executive Benefits*, the Sixth Circuit also confronted the question of whether parties to a lawsuit may consent to entry by the bankruptcy court of a final order on a matter on which the court otherwise lacked constitutional authority to finally adjudicate. The defendant in Waldman had expressly consented to entry of a final order by the bankruptcy court on all of plaintiff's claims. Thus, the question became whether the defendant could effectively waive the requirement that only an Article III judge may, consistent with the Constitution, enter a final order with respect to a debtor/plaintiff's damage claims. The Sixth Circuit held the defendant's waiver to be ineffective because it implicated not only the defendant's personal right, but also the structural principle advanced by Article III, a principle that was not the defendant's to waive. Thus, according to the Sixth Circuit, the bankruptcy court could not enter a final order on the plaintiff's affirmative claims, notwithstanding the defendant's explicit consent. The Ninth Circuit's *Executive Benefits* decision just months later created a circuit split on the consent question.[10]

As did the Ninth Circuit, the Sixth Circuit in *Waldman* also flagged the so-called statutory gap as a potential issue. However, because Waldman did not involve a claim that was statutorily core but outside the bankruptcy court's constitutional authority, the court declined to address whether the statutory gap precluded bankruptcy judges from issuing proposed findings of fact and conclusions of law on such claims.

The Supreme Court's Decision in Executive Benefits

The Supreme Court granted *certiorari* seemingly for the purpose of resolving the split that had emerged among the circuits; however, the Court stopped short of ruling on the primary issue causing the split, instead determining that the federal statute creating the constitutional problem also contains a self-curing mechanism that allows "Stern Claims" (claims identified in the statute as "core" claims but which Article III of the Constitution prohibits bankruptcy courts from finally adjudicating) to be ruled upon by a bankruptcy court by issuance of proposed findings of fact and conclusions of law, subject to de novo review by the district court.

"Stern Claims" and the Statutory Gap

In its *Executive Benefits* decision, the Supreme Court expressly chose not to decide the consent issue. Instead, it laid down the procedure that must be followed by a bankruptcy court when addressing a Stern Claim.

The Court resolved the issue of the supposed "statutory gap" by explaining that the plain text of the relevant statute operates to close the gap. Because the statute contains a "severability provision," which allows the remainder of the statute to apply to those portions of the statute that remain constitutionally valid, the statute continues to apply to Stern Claims by treating them as what they are in reality—non-core claims.[11] In other words, the statute's severability provision cures its constitutional defect, by allowing Stern Claims to be decided by the bankruptcy court as non-core claims.

The statute also supplies the procedure that must be followed by a bankruptcy court deciding a Stern Claim: that is, it must submit proposed findings of fact and conclusions of law for *de novo* review by the district court.[12] In this case, the district court had not, strictly speaking, treated the bankruptcy court's order as proposed findings of fact and conclusions of law; however, because the district court did, in fact, review the bankruptcy court's grant of summary judgment *de novo* and issue a written opinion affirming the bankruptcy court's decision, the defendant received the equivalent review it would have received had the statutory procedure been precisely followed, and any resulting error was thus cured.

To the surprise of many observers—including, presumably, the petitioner and respondent in *Executive Benefits*, whose Supreme Court briefing focused, for the most part, on the issue of consent—the Supreme Court elected not to decide the question of whether a party's consent to bankruptcy court adjudication on a Stern Claim may operate to effectively negate any constitutional concerns. One can speculate that the Court's unanimous decision to resolve the case on the basis of the severability provision in the underlying statute may well have been driven by a deep division in the Court on the fundamental constitutional question presented by *Executive Benefits* – a question that at some point will need to be resolved.

Where Do We Go From Here?

In light of Executive Benefits, the question becomes: Where does this leave us? The short answer is that just as it did in Stern, the Court left a number of unanswered questions in *Executive Benefits*.

10 A number of courts outside the Sixth and Ninth Circuits have also addressed the consent issue. Courts aligned with the Sixth Circuit include *BP RE, L.P v. RML Waxahachie Dodge, LLC (In re BP RE, L.P.)*, 735 F.3d 279, 288 (5th Cir. 2013) (parties cannot consent to circumvention of Article III that impinges on structural interests of judicial branch); and *Wellness International Network, Ltd.* v. Sharif, 727 F.3d 751, 771 (7th Cir. 2013) (consent is insufficient to overcome structural framework of Article III).

11 *See Executive Benefits Insurance Agency*, 573 U.S. at ___; 28 U.S.C. § 157(c).

12 *Executive Benefits Insurance Agency*, 573 U.S. at ___.

The lower courts' conflicting views on parties' ability to consent will doubtless continue to sharpen, thus intensifying the debate. Quite notably, the implications are not necessarily limited to the bankruptcy system. Indeed, the same rationale that led the Sixth Circuit in *Waldman* (and other courts as well) to determine that parties may not consent to certain adjudications by Article I bankruptcy judges could also apply to other non-Article III judges, including federal magistrate judges.

In at least three circuits, a party may not consent to bankruptcy court adjudication of Stern Claims. In these jurisdictions (and any others that may join them), all Stern Claims must be resolved by the district court. Adding to the confusion is that it is not always entirely plain what claims are, in fact, Stern Claims. Until the universe of Stern Claims is more clearly defined, parties and courts in these circuits will need to expend additional resources and time determining whether their claims may be heard by the bankruptcy court or must instead be adjudicated by the district court. Further complicating matters—at least for those courts holding that consent is an effective cure—is the question of whether such consent must be explicit, or instead whether it may be implicit.

Postscript

In *Executive Benefits*, the Court applied a Band-Aid fix to the question of the extent of the bankruptcy courts' constitutional adjudicative authority. While this temporary measure allows the bankruptcy system to adequately function for the time being, it leaves the fundamental question of consent unanswered during the interim.

Very interestingly, though, only a few weeks after issuing its *Executive Benefits* decision, the Court granted a petition for writ of certiorari to review the Seventh Circuit's *Wellness International* decision, in which the Seventh Circuit appeals court aligned with the Sixth Circuit view that consent is insufficient to cure any constitutional proscriptions.[13] In its opinion granting cert, the Court agreed to take up the ultimate consent question during the current term. Equally as intriguing, the Court also agreed to consider the question whether—assuming consent is held to be effective to overcome any constitutional prohibition—implied consent, based on a litigant's conduct, would also be sufficient to satisfy Article III of the Constitution.

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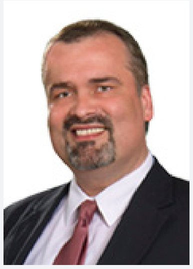

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13 See *Wellness International Network, Ltd. v. Sharif*, 2014 U.S. LEXIS 4693 (July 1, 2014); and *Wellness International Network, Ltd. v. Sharif*, 727 F.3d 751, 771 (7th Cir. 2013). *See also* note 10 above.

BANKRUPTCY TAXES

FORREST LEWIS, CPA
Section Editor

IRS Shows Competence and Brings Reasonableness to Written Opinion Rules

Effective June 12, 2014 the Internal Revenue Service published final regulations liberalizing the rules for written advice and practice before the IRS, known as "Circular 230". One of the most welcome changes is the dropping of the requirement for the "no reliance" legend on informal tax advice rendered to clients. A previous IRS regime had implemented draconian rules in 2005 aimed at preventing aggressive legal opinions on tax shelters but the dragnet of those rules caught up many small, innocent advice situations. Now, the IRS has repealed the most drastic of those rules and put emphasis going forward on principles of "competence" by the practitioner and "reasonableness" in the advice given.

1. The definition of "covered opinion" is repealed.

2. The final regulation states affirmatively the standards to which a practitioner must adhere when providing written advice on a Federal tax matter. It requires, among other things, that the practitioner base all written advice on reasonable factual and legal assumptions, exercise reasonable reliance, and consider all relevant facts that the practitioner knows or reasonably should know. A practitioner must also use reasonable efforts to identify and ascertain the facts relevant to written advice on a Federal tax matter.

3. It also requires that a practitioner must possess the necessary competence to engage in practice before the Internal Revenue Service. Competent practice requires the appropriate level of knowledge, skill, thoroughness, and preparation necessary for the matter for which the practitioner is engaged. A practitioner may become competent for the matter for which the practitioner has been engaged through various methods, such as consulting with experts in the relevant area or studying the relevant law.

4. The new regulation does not require that the practitioner describe in the written advice the relevant facts (including assumptions and representations), the application of the law to those facts, and the practitioner's conclusion with respect to the law and the facts. Rather, the scope of the engagement and the type and specificity of the advice sought by the client, in addition to all other appropriate facts and circumstances, are factors in determining the extent to which the relevant facts, application of the law to those facts, and the practitioner's conclusion with respect to the law and the facts must be set forth in the written advice. While the IRS has said that practitioners must stop using the former notification that it required stating a taxpayer may not rely on a given written advice for relief from penalty, some IRS officials have encouraged continued use of a disclosure based on the new rules.

5. The determination of whether a practitioner has failed to comply with the new requirements will be based on all facts and circumstances, not on whether each requirement is addressed in the written advice.

6. Consistent with the former regulation, the final regulations provide that a practitioner must not, in evaluating a Federal tax matter, take into account the possibility that a tax return will not be audited or that an issue will not be raised on audit. However, the new regulation does permit the practitioner to take into account the chance that the taxpayer's position may enhance the opportunity for a settlement with the IRS.

IRS Grants Blanket Relief for Consolidated Subs Which Failed to Elect

A common error in the filing of consolidated group corporate income tax returns is failure to file an election to consolidate a new subsidiary, even though the sub is included in the information in the return. This can happen with a newly formed or acquired subsidiary.

Technically, a Form 1122 *Authorization and Consent of Subsidiary Corporation to Be Included in a Consolidated Income Tax Return* is required in order to properly be included in a consolidated group tax return. In practice, a Form 1122 is typically filed when the group first elects consolidated return treatment but is sometimes missed when a new sub is added. Under the following circumstances, IRS will treat the election as having been made, even though omitted:

(i) When the income and deductions of the member were included in the consolidated return;

(ii) When no separate return was filed by the member for that taxable year; and

(iii) When the member was included on Form 851, *Affiliations Schedule*.

Source: IRS Rev. Proc. 2014-24 on Tax Treatment of Affiliated Groups Failing to File Form 1122

IRS Proposes Regulation to Attack "Bottom Guarantees"

One partnership technique used to create tax basis for certain partnership tax losses when the partner actually incurs almost no risk of economic loss is the "bottom guarantee." In the "bottom guarantee", the partner only guarantees the lender for the last portion of the debt. Example: Partner A obtains tax basis for losses in a partnership by guaranteeing $100,000 of a $3,000,000 bank loan. The conditions of the guarantee provide that Partner A will have to pay only if the collateral and other guarantees amount to $100,000 or less. Thus, Partner A has a lot of protection from having to perform on the guarantee.

There is a similar technique called "bottom deficit restoration obligation" which the regulation is intended to eliminate, but I will not go into the details of those mechanics. The proposed regulation (NPRM REG-119305-11, 01/30/14), provides the guarantee will not be respected by IRS as providing tax basis unless:

1. The partner is required to maintain a commercially reasonable net worth throughout the term of the payment obligation; or subject to commercially reasonable contractual restrictions on transfers of assets for inadequate consideration. (i.e., they are doing away with the current assumption that a person subject to a payment obligation will always perform that obligation).

2. The partner or related person is required periodically to provide commercially reasonable documentation regarding the partner's or related person's financial condition.

3. The term of the payment obligation (guarantee) does not end prior to the term of the partnership liability.

4. The payment obligation must not require that the primary obligor or any other obligor with respect to the partnership liability directly or indirectly hold money or other liquid assets in an amount that exceeds the reasonable needs of such obligor.

5. The partner or related person received arm's length consideration for assuming the payment obligation.

6. In the case of a guarantee or similar arrangement, the partner or related person must be liable up to the full amount of such partner's or related person's payment obligation if, and to the extent that, any amount of the partnership liability is not otherwise satisfied.

Some commentators have criticized the proposal because well situated partner entities such as a large corporation or wealthy individual would not normally need to prove net worth or disclose financial statements. Further, the guarantee would not normally have to run to the end of the loan term when the underlying property would cover the balance of the loan and in many cases no separate fee is demanded in the market.

Election to defer effective date for 7 years—the proposed regulation contains an election to defer the effective date of the tests above, some documents are now being written enabling the election in case the regulations become final.

Supreme Court Rules Inherited IRA Not Exempt From Bankruptcy Estate

The US Supreme Court has largely put to rest the question of whether an inherited Individual Retirement Account enjoys an exemption from the bankruptcy estate in the event of the bankruptcy of the heir. The Court ruled that an inherited IRA does not so qualify and may be reached by creditors. In the case of *Clark et Ux. v. Rameker Trustee, et al.* [573 U. S.___(2014)] when petitioners filed for Chapter 7 bankruptcy, they sought to exclude roughly $300,000 in an inherited IRA from the bankruptcy estate using the "retirement funds" exemption of Bankruptcy Code §522(b)(3)(C). The Bankruptcy Court concluded that an inherited IRA does not share the same characteristics as a traditional IRA and disallowed the exemption. The case underwent a series of reversals as it went up the line until it was finally heard by the Supreme Court.

Justice Sotomayor wrote the unanimous opinion for the Supreme Court which ruled that funds held in inherited IRAs are not "retirement funds" within the meaning of §522(b)(3)(C) on these grounds:

(a) The ordinary meaning of "retirement funds" is properly understood to be sums of money set aside for the day an individual stops working. Three legal characteristics of inherited IRAs provide objective evidence that they do not contain such funds. First, the holder of an inherited IRA may never invest additional money in the account. Second, holders of inherited IRAs are required to withdraw money from the accounts, no matter how far they are from retirement. Finally, the holder of an inherited IRA may withdraw the entire balance of the account at any time—and use it for any purpose—without penalty.

(b) This reading is consistent with the purpose of the Bankruptcy Code's exemption provisions, which effectuate a careful balance between the creditor's interest in recovering assets and the debtor's interest in protecting essential needs. Allowing debtors to protect funds in traditional and Roth IRAs ensures that debtors will be able to meet their basic needs during their retirement years. By contrast, nothing about an inherited IRA's legal characteristics prevent or discourage an individual from using the entire balance immediately after bankruptcy for purposes of current consumption. The "retirement funds" exemption should not be read in a manner that would convert the bankruptcy objective of protecting debtors' basic needs into a "free pass."

(c) Petitioners' counterarguments do not overcome the statute's text and purpose. Their claim that funds in an inherited IRA are retirement funds because, at some point, they were set aside for retirement, conflicts with ordinary usage and would render the term "retirement funds," as used in §522(b)(3)(C), superfluous. Congress could have achieved the exact same result without specifying the funds as "retirement funds."

Thanks to Attorney Katherine Lewis, Grant Newton and Dennis Bean for their assistance.

Supreme Court Rules in Favor of IRS on Severance FICA Tax

We have been following the Quality Stores case in which several lower courts had ruled that severance payments made to employees in a Chapter 11 proceeding were not wages subject to FICA taxes. In a unanimous US Supreme Court decision written by Justice Kennedy, the Court ruled that the underlying statute had been amended several times removing the original exemption for severance payments on which the taxpayer was relying. The severance payments were held subject to FICA tax, as well as income tax. This probably broadly settles the issue in favor of the IRS position of taxability for all purposes of severance payments. [*United States v. Quality Stores, Inc., et al.*, March 25, 2014]

Case Provides Good Reminder: Not All Taxes Can Be Priority

A recent court case illustrates the fact that not all pre-petition taxes assessed by the Internal Revenue Service (or state agencies) qualify to be classified as "priority taxes" for bankruptcy purposes under Bankruptcy Code Section §507(a)(8). [*In re Desert Capital REIT, Inc., Debtor. David M. Bagley, Trustee for the DCR Liquidating Trust, Appellant and Cross-Appellee v. United States of America, Appellee and Cross-Appellant.*, U.S. Bankruptcy Appellate Panel, Ninth Circuit, 2014-2 U.S.T.C. ¶50,410, (Aug. 11, 2014)]

In order to be eligible to be a priority tax under the Bankruptcy Code, a tax must meet certain time frames (not discussed in this article) and must be:

(A) a tax on or measured by income or gross receipts reported on a return which was not evasive;

(B) a property tax incurred before the commencement of the case;

(C) a tax required to be collected or withheld and for which the debtor is liable in whatever capacity (e.g. withheld employee taxes);

(D) an employment tax on a wage, salary, or commission earned from the debtor before the date of the filing of the petition (e.g. the employer share of FICA);

(E) an excise tax on a transaction occurring before the date of the filing of the petition;

(F) a customs duty arising out of the importation of merchandise entered for consumption within one year before the date of the filing of the petition; or

(G) a penalty related to a claim of a kind specified above and in compensation for actual pecuniary loss.

A key to understanding the interpretation of this section is found in item (G), the requirement that in order to become a priority, a penalty must compensate for "actual pecuniary loss" which means that it roughly corresponds to an amount of tax which the government has lost under the facts of the case. A common issue in this area is the amount of penalties and sometimes "taxes" which bear no relationship to the underlying tax rate which is intended to be collected by the governmental unit. Taxes or penalties in excess of the stated tax rates cannot qualify as priority taxes. This case is a good illustration of that distinction.

The case happened to involve a Real Estate Investment Trust which was subjected to an involuntary Chapter 11 petition in 2011. The REIT tax rules found in the Internal Revenue Code have a rather unusual provision for assessing taxes when the Internal Revenue Service decides that a REIT has made an unfair allocation of expenses or income with a related party in order to reduce its income taxes. In this case the IRS assessed tax under a REIT tax provision found in IRC Section 857(b)(7)(A) which is akin to a "prohibited transaction" penalty. This may have been a case of the IRS overreaching as the amount of the penalty is 100% of the excessive deductions, not 35% which would normally be the maximum federal income tax benefit which the taxpayer had unjustly realized. Thus, IRS was attempting to collect much more than the 35% "pecuniary loss" which the federal government suffered. Though the government argued that at least 35% of the IRS assessment should have been allowed as a priority tax, both the bankruptcy court and a bankruptcy appeals panel ruled that based on the Internal Revenue Code section under which the IRS made the assessment, the entire 100% was a penalty and must be classified as a general, unsecured claim on the bankruptcy estate.

Some other types of pre-petition taxes or penalties which have been found to be ineligible for priority status are (per Collier):

- User fees or charges assessed by a governmental entity for the privilege to use public facilities are not treated as excise taxes in the bankruptcy context.
- Failure to make minimum funding contribution to a pension plan under IRC 4971(a).
- In some states, water and sewer assessments have been determined to not be taxes.
- Some cases have held unpaid worker compensation levies by a state to not be taxes.
- The premature qualified plan withdrawal penalty of 10% under IRC Sec. 72 has been held to be a non-pecuniary penalty.
- The Pension Benefit Guaranty Corporation has generally been unsuccessful in seeking priority tax status for the liability it inherits from terminating pension plans.

Conclusion: Before a tax or penalty claim is classified as a "priority", consideration should be given to whether it compensates the governmental unit for "pecuniary loss" or is punitive or a user fee by nature.

Another Setback for IRS: Refund Contingency Fee Prohibition Struck Down

The Internal Revenue Service has received two major setbacks in recent years—first the US District Court invalidated a major part of the rules for practitioner admission and regulation it had formulated [*Sabina Loving case*, 2013], then recently it overturned the Service's ban on contingency fees charged to prepare tax refund claims. [*Ridgely v. Lew*, July 16, 2014].

The IRS Regulation known as "Circular 230" prescribes rules governing the practice of attorneys, certified public accountants, enrolled agents, enrolled actuaries, and appraisers before it. Circular 230 was promulgated by the IRS under authority granted to it by statute. In order to prevent exploitation of the audit selection process, sometimes called the "audit lottery," Circular 230 provided that, in most circumstances, "a practitioner may not charge a contingent fee for services rendered in connection with any matter before the [IRS]." However, Circular 230 does allow for a limited number of exceptions.

The term "contingent fee" is defined by the regulation as "any fee that is based, in whole or in part, on whether or not a position taken on a tax return or other filing avoids challenge by the IRS or is sustained either by the IRS or in litigation," and also includes "a fee that is based on a percentage of the refund reported on a return, that is based on a percentage of the taxes saved or that otherwise depends on the specific result attained." The regulations define "matter before the Internal Revenue Service" as: "tax planning and advice, preparing or filing or assisting in preparing or filing returns or claims for refund or credit, and all matters connected with a presentation to the IRS or any of its officers or employees relating to a taxpayer's rights, privileges, or liabilities under laws or regulations administered by the IRS. Such presentations include, but are not limited to, preparing and filing documents, corresponding and communicating with the IRS, rendering written advice with respect to any entity, transaction, plan or arrangement, and representing a client at conferences, hearings, and meetings."

Ruling

In the *Loving* case, the court had previously ruled that the underlying statute never intended that IRS regulate tax practitioners in the preparation of original tax returns. In the *Ridgely* case, the court went on to hold that the history of the underlying statute indicates that the statute's scope never encompassed the preparation and filing of refund claims either. The process of filing an Ordinary Refund Claim—again, before any back-and-forth with the IRS—is similar to the process of filing a tax return in that both take place *prior* to any type of adversarial assessment of the taxpayer's liability. If a "tax-return preparer does not practice *before the IRS* when he simply assists in the preparation of someone else's tax return," then a CPA hardly "practices" before the IRS when he simply prepares and files a taxpayer's refund claim, before being designated as the taxpayer's representative and before the commencement of an audit or appeal. Essentially it said that advocating a taxpayer's position to the IRS in some sort of audit proceeding is "practice before the IRS" and that preparing a tax return does not make a practitioner the taxpayer's representative. The court issued a permanent injunction against enforcement of the IRS rule on contingent fees in tax refund cases.

DOL Updates Guidance on Missing Participants in Terminated Retirement Plans

The US Department of Labor has updated its guidance to administrators of terminating qualified retirement plans on searching for missing plan participants and options for distributing their benefits. [Field Assistance Bulletin No. 2014-01] The guidance is fairly similar to that issued in 2004 but does contain a few changes. What to do with the retirement plan assets of missing participants is a fairly common issue faced by bankruptcy professionals.

The guidance notes that since both the Social Security Administration and Internal Revenue Service no longer forward letters from plan administrators, the DOL requires that plan administrators meet their fiduciary duty to search for missing participants by taking the following steps:

1. **Certified Mail.** The bulletin stresses an initial mailing using certified mail, presumably with return receipt requested. The Department provides a model notice that can be used for such mailings.

2. **Check Related Plan and Employer Records.** While the records of the terminated plan may not contain current address information, it is possible that the employer or another of the employer's plans, such as a group health plan, may have more up-to-date information. For this reason, plan fiduciaries of the terminated plan must ask both the employer and administrator(s) of related plans to search their records for a more current address for the missing participant.

3. **Check with Designated Plan Beneficiary.** In searching the terminated plan's records or the records of related plans, plan fiduciaries must try to identify and contact any individual that the missing participant has designated as a beneficiary (e.g., spouse, children, etc.) to find updated contact information for the missing participant.

4. **Use Free Electronic Search Tools.** Plan fiduciaries must make reasonable use of Internet search tools that do not charge a fee to search for a missing participant or beneficiary. Such online services include Internet search engines, public record databases (such as those for licenses, mortgages and real estate taxes), obituaries and social media. While DOL stops short of requiring use of paid internet search services, they say that in the case of large pending account balances, it may be justified.

Distribution options

If after performing the above steps you still have participants you cannot locate, these are the alternatives for distributing plan benefits in a terminating plan:

1. **Individual Retirement Plan Rollovers—Preferred Distribution Option.** The law requires plan fiduciaries to consider distributing missing participant benefits into individual retirement plans (i.e., an individual retirement account or annuity). DOL states an individual retirement plan is more likely to preserve funds for retirement than any other option. Assuming you can find a financial institution willing to accept the IRAs, a distribution that qualifies as an eligible rollover distribution from a qualified plan, which is handled by a trustee to trustee transfer into an individual retirement plan, will avoid immediate taxation. An eligible direct rollover results in the deferral of income tax, avoids the 20 percent mandatory withholding, and avoids any 10 percent additional tax for early distributions that might otherwise apply based on the participant's age and related facts. Funds in the individual retirement plan continue to grow tax-free and income taxes do not need to be paid until funds are withdrawn.

2. **Federally Insured Bank Accounts.** Plan fiduciaries may consider establishing an interest- bearing federally insured bank account in the name of a missing participant, as long as the participant would have an unconditional right to withdraw funds from the account. Assuming you can find a financial institution willing to accept the deposits, concerns about the customer identification and verification provisions (CIP) of the USA PATRIOT Act have been worked out. The financial institution regulators have said they interpret the Act's CIP requirements for an account (including an individual retirement plan or federally insured bank account) established by an employee benefit plan in the name of a former participant (or beneficiary) of such plan to apply the CIP compliance program only at the time a former participant or beneficiary first contacts such institution to claim ownership or exercise control over the account. CIP

compliance will not be required at the time an employee benefit plan establishes an account and transfers the funds to a bank or other financial institution for purposes of a distribution of benefits from the plan to a separated employee.

3. **State Unclaimed Property Funds.** Plan fiduciaries may also consider transferring/escheating missing participants' account balances to state unclaimed property funds in the state of each participant's last known residence or work location. Some states accept such distributions on behalf of missing participants.

4. **Unacceptable Distribution Option.** 100% Income Tax Withholding Is Not An Option. Withholding 100% of a missing participant's benefits would in effect transfer the benefits to the IRS. DOL has concluded that using this option is not in the best interest of participants and beneficiaries and would violate ERISA's fiduciary requirements.

Link to complete bulletin:

http://www.dol.gov/ebsa/regs/fab2014-1.html

For information about Section Editor, Forrest Lewis—see p. 27.

HIGHER ED, *continued from page 17*

Salaries have climbed faster than inflation, with some faculty, coaches, and administrators making $1 million or more; for example, professors at Smith College earn an average of $130,000, even with declining teaching loads. And government regulatory burdens cause nearly all institutions to have legal counsel and compliance officers that were unheard of three or four decades ago. It should be noted that most of these cost pressures come from everything except the core business of educating and turning out good citizens.

Declining Status

In spite of the greatly increased costs, the social stature and perceived value of a college degree is declining. Families are questioning whether a college degree is still a ticket to upward mobility. Stories abound of jobless or underemployed graduates and credit-ruining college debt. Many institutions are perceived as not delivering value commensurate with the extra costs. Among the concerns of this author is that many colleges are no longer teaching values, character, critical thinking, and citizenship because the prevailing political correctness today says there are no absolutes or values better than others. According to *Academically Adrift: Limited Learning on College Campuses* by Richard Arum and Josipa Roksa (The University of Chicago Press, 2011), 45% of students surveyed at major universities demonstrated no significant learning in the first two years in critical thinking, complex reasoning, or writing, 36% do not improve in those categories over four years, and many others only marginally improve.

Public Relations

There is a tendency of boards and administrations to deny reality—the ostrich effect. After all, these traditional institutions have survived all changes to date! There are tremendous pressures on them to deliver a positive public relations message and even the insiders are "drinking the cool-aid."

Rise of For-Profits

A major cultural factor in higher education has been the rise of for-profit educational institutions. Consider these statistics about for-profit institutions:

- In 2010, enrolled 2.5 million students, they had $29.6 billion in revenue and very high profit margins.
- In the period 2000-2012, they had a compound annual growth in revenue of 16%.
- In 2012, they had 11% of all higher education enrollments, 25% of financial aid, 47% of loan defaults, and enrolled 65% of students over age 25.
- FP institutions receive 80% of revenue from federal aid programs, averaging $6,997 per student.
- The largest 14 institutions had an average market cap of $776.5 M, with Apollo, DeVry, and Grand Canyon Education, Inc. at or approaching $2 B each; Apollo had EBITDA of $758 M in the most recent reported year.
- There were 74 mergers through 2010 for $11.8 B; 88 transactions since 1999 for $12.5 B.
- 25% of revenue goes to advertising and recruiting; 17% to educating; 19% to profits.
- Title IV regulations now forbid commission/bonus/incentive payments for recruiting.
- From 2011 to 2012, for-profit enrollments declined 7%, while overall higher education enrollment declined only 1.8%.

Prevailing Model

The longstanding paradigm has followed the wealthy schools: high tuition costs; high discounting (NACUBO—first-time, full-time students paid an average of 57.6% of the sticker price; requires large number of full-paying students who are hard to find; propped up by 820,000 international students primarily from China, India, Korea, and Saudi Arabia); expensive instruction—low faculty loads and small class sizes; residential life on beautiful campuses; relatively rigid schedules and calendars with little flexibility; one-size fits all curriculum; limited course and degree offerings; leadership recruited as stewards to preserve the best of the university, not as innovative leaders; stately (i.e., expensive) buildings; massive investments in brick & mortar; molasses-style movement (one report of two years to change the name of a degree); shared governance; very high marginal cost and little scalability. It coasts on claimed uniqueness – learning for its own sake; research; and environment. In two words: ivory tower.

Is the higher education industry still venerable? Yes, but there is a growing sense of unease. Could such stable institutions be disrupted? For a possible precursor, look at print media: there has been a 60% decline in print advertising in 10 years; 150-year old newspapers are closing; newspapers are selling for 10-15% of prior value. Look also at music, books, POTS, Cable TV—all information-based industries impacted by technology. Can the same thing happen to higher education? We are compelled to answer in the affirmative if we keep in mind that higher education is an information-based industry subject to most of the same political, geographic and economic forces as these examples.

External Forces That Challenge Sustainability

Each one of these forces deserves a separate discussion and deeper consideration. We have learned in the past fifty years that change is the only constant in our world. As Will Rogers said, "Even if you're on the right track, you'll get run over if you just sit there."

Demographics

It is reported that only 16% of today's college students fit the traditional undergraduate student model—ages 18-22, full-time students, living on campus.

Competition

- For-Profit – Apollo/Phoenix, higher market share
- Non-Profit – Georgia Tech, offering computer science masters for $7,000
- International – number of Chinese colleges in 1999 was 1,071; by 2009, it was 2,305
- Increased cost of recruiting – averaging $2,000-4,000 in many colleges

Cultural Shifts (Can Be Good or Bad)

Attention spans are shorter; people look for quick fixes; sound bites rule the debates; there seems to be a general lack of depth—everything must be simplified and there is less evidence of critical thinking. Families are questioning the value of college. There is a wholesale abandonment of long-held cultural, political, economic, and moral values. In this context, what passes for a college education is being redefined. Much of what passes for higher education brings to mind former Boston University President John Silber's quip: "Higher than what?"

There is what many consider to be an excess of soft courses to accommodate cultural changes. As economist Thomas Sowell recently noted, these changes "allow students to spend years in college without becoming educated in any real sense." In Oklahoma (a generally conservative state) institutions of higher education offer courses such as the following—Badminton, Principles of Floral Arranging, Beginning Bowling, Puppetry I, Billiards, Star Wars and the Hero's Journey, The Beatles and the Counterculture, Disney Dogs and Popular Pets; Monsters, Mummies, Myths: A Study of Bad Archaeology and Pop Culture; The Evolution of a Media: Hip Hop Narrative; Environmentally Conscious Living; South Park and Stereotypes: TV Racism in the Obama Era; Jersey Shore-GRC: Depictions of Gender, Race and Class on The Shore—but pay lessening attention to math, language, history, science, economics, and other liberal arts courses. An Oklahoma professor once published academic research titled, "Towards Queering Food Studies: Foodways, Heteronormativity, and Hungry Women in Chicana Lesbian Writing." This degradation of the curriculum can be found multiplied thousands of times throughout U.S. higher education. Is it any wonder that families are losing faith in the value of higher education—or that its cost is escalating?

Many observers associate the above trends with what is referred to as the dumbing down of K-12 and college education and an increasing lack of preparation—emotional, intellectually, and socially—for college or for life. As a result, higher education has to invest heavily in remedial courses. It was found in one study that eighth grade tests of the 1800's were beyond the capability of many of today's college graduates. The stories of abysmal learning at many universities have been well documented, and are compounded by recent controversies involving cheating, plagiarism and reduced academic standards for star athletes.

Technology

It is difficult to overstate the impact of technology—it is transforming delivery of much academic content while at the same time comprising the subject matter of many courses/majors and providing a catalyst to cultural change. The Internet is destroying or drastically altering all industries (including education) that rely on the sale of information as evidenced by the following facts. The National Center for Education Statistics reports that 5.5 million students took online classes in 2012, and about half of those were in fully online programs. Between 2000 and 2010 online enrollments had a 31% compound annual growth rate. Online enrollments already account for 58% of for-profit enrollment. Massive Open Online Courses (MOOCs) are gaining respect via offerings such as edX (Harvard and MIT); Coursera (Stanford, Penn, Princeton, University of Michigan, and UC Berkeley); Udacity; and Western Governors University. There are now 528 schools with online degrees. *US News* is now ranking online degrees and received 1,000 applications in a recent year.

Online learning is recognized for many benefits: convenience; mass customization vs. fit our model; flexibility; cost; interactive; and can accommodate different learning styles. It also has many impacts on various aspects of the learning process. Faculty roles are changing from "sage on stage" to "guide on the side." Studies have shown that students learning through technology do as well on tests as those in the classroom (possible self-selection?) and the time required is much less. Credentialing is the key to continuation of the dramatic increases in online education. It is now being promoted by the American Council on Education (ACE) and many schools, and regional accrediting agencies are experimenting with accreditation of online programs. Anant Agarwal, MIT professor of computer science and edX's first president, told the *Los Angeles Times*, "MIT's and Harvard's mission is to provide affordable education to anybody who wants it." That should put the fear into the higher education industry.

Origin of the Higher Education Bubble

Much has been made of the "college bubble" in recent years; a Google search by the author returned 87,300,000 hits for "college bubble"! Let us examine some key factors that have created and continue to inflate the bubble.

- The federal government changed the funding paradigm for higher education from family resources to government and debt.

- The tremendous growth in student loans has created what has been labeled the "Student Debt Bomb." Next to housing, higher education is now the highest source of debt—even above credit cards—at $1 Trillion, or one-third of all personal debt. Student loan debt now averages $23,000+ per graduate, and some are well over $100,000. The author is personally acquainted with cases where graduate students accumulated over $200,000 in student loans. Default on payments is at an all-time high. It is even said that such debt makes some borrowers now unmarriageable!

- Approximately 3.1% of America's GDP was spent on higher education in 2007. (Organization for Economic Co-operation and Development (OECD), "Education at a Glance, 2010: OECD Indicators"). Some 2.1% of this ($300 billion) was tax-funded. As with any bureaucracy that is funded by the government and which is granted a licensing monopoly, the conduct of higher education depends on making sure that funding and licensing continue.

The 2005 Bankruptcy Abuse Prevention and Consumer Protection Act removed private student loans from bankruptcy protection. Since it was passed, however, there have been several bills to try to overturn it, including S. 114: Fairness for Struggling Students Act of 2013; and H.R. 2028: Private Student Loan Bankruptcy Fairness Act of 2011.

Further Examination of the Bubble

Current developments in the higher education industry may be compared to the all-too-familiar Housing Bubble. Were bankers greedy? One might respond yes, but they were just as greedy before the bubble; however, before the bubble, bankers were also cautious. Profit appealed to their greed but risk appealed to their caution. The balancing forces of greed and caution—profit and risk—are what cause a free market to produce the right amount of loans. Many observe that what changed was government meddling removed caution by separating loan profits from loan risks. The government (i.e., the taxpayers) shouldered the mortgage risks and banks got to keep the profits without risk. Government created conditions for wholesale failure, and failure ensued.

Just as the government sought to engineer people into houses, it now seeks to engineer people into higher education. Congress established Sallie Mae in 1972 to encourage banks to loan more money for college. The Affordable Care Act of 2010 allowed the government to loan money directly to students (many have forgotten this legislation included a list of provisions for Higher Education). The following year the Taxpayer Relief Act extended tax breaks to student loan borrowers. Concurrently, the Federal Reserve artificially kept interest rates at historically low levels, making college loans cheaper.

By law, lenders cannot even deny Stafford and Perkins loans (types of federal student loans) based on the borrower's credit or employment status. But, one might ask, what other reason is there to deny a loan? And just as home buyers took out loans to speculate on houses they could never hope to afford, in many cases students are taking out loans to cover educations they cannot complete and which often do not hold value in the market even if completed. In spite of cultural and political claims that in the U.S. higher education is for all, the truth is that in recent years only half of graduates are actually finding employment that requires a college education.

Government intervention has again separated profit from risk—colleges and universities get to keep tuition profits while taxpayers are left to shoulder the risk of student loan default. Once again government has succeeded in creating conditions for wholesale failure; and failure is upon us. At the same time, the price of a college education soared—just as one would expect from a market flooded with cheap money.

While the U.S. Higher Education Bubble isn't an *asset* bubble like stock or real estate bubbles, it is a *bubble-like* phenomenon with very similar risks and implications as asset bubbles. The crucial components of all bubbles are present in the US College Bubble: a highly convincing and partially-legitimate cultural appeal, soaring prices and profits, decreasing affordability, a highly overpriced/overvalued product, blatant profiteering, a "gold rush" mentality, extrapolation of the boom's growth far into the future and debt-fueled overinvestment/overexpansion. The end result will be similar to what asset bubbles experience when prices become overvalued and unaffordable—prices will be forced down to realistic levels again and large-scale industry downsizing will occur, resulting in massive capital losses.

See "The College Bubble (including Education and Student Loan Bubble)" by Jesse Columbo, www.TheBubbleBubble.com/college-bubble/

Decline in State Government Support

Interestingly, in recent years state governments have been moving rapidly toward a "user pays" model by providing less support for state institutions.

Stratification of Higher Education

Academic institutions are increasingly divided into the haves and have-nots. Wealthy institutions frequently outbid one another for faculty and resources, and it is no longer unusual to hear of multi-billion dollar fund-raising campaigns. Less well funded schools are unable to compete with them, and this is undermining educational diversity which has long been a major source of greatness in American higher education. Eighty percent of small schools have experienced declines in enrollment in the past 3 years, and they are trying to address it with massive increases in the discount rate—thus further undermining their own revenue source—a deadly downward spiral.

Accreditation

It was once the higher education mote, protecting established institutions from the forces of competition, but accreditation is now recognizing other ways of validating education. Accreditation will soon no longer be based on seat time, but rather on content—what was learned, not how it was learned.

Even ACE is calling for "learning assessment accreditation" or competency-based education, which allows students to earn credit based on what they know, not where or how they learned it. Over 600 corporations and government agencies are now establishing their own accrediting criteria. In addition, there is a push toward *occupational training*, judging education by its relevance to finding jobs; employers and others funding education are being given a say in curriculum content which in the past has been the sole purview of the faculty.

Other Pressures Impacting Viability

Among the list of challenges facing these institutions, several other burdens are also growing rapidly. Among them are: investment returns are declining, impacting payouts from endowments; regulatory reporting requirements and legal causes of action are proliferating; research is now highly commercialized and there is less fundamental original research. *Commodification of information* is a significant paradigm shift with impacts that are difficult to measure – with so much online and in libraries, information is no longer the private treasure of universities; again causing the public to question the value of higher education.

There is also the problem of ever-increasing government regulation which adds to costs while not adding value. *Composite Scores* are now evaluating all recipients of federal financial aid in a one-size-fits-all effort to determine if institutions are improperly capitalized, illiquid, and sustainable, but these scores are skewed by hedging techniques and other factors. Over 100 institutions failed the tests in the most recent year. Recently enacted *gainful employment regulations* (which require institutions to report 36 data elements) will cost higher education an estimated $60 million to comply initially and $10 million per year thereafter.

To top it off, educational institutions *cannot use bankruptcy restructuring* without losing Title IV funding and accreditation and Rating Agencies such as S&P and Moody's are now *decreasing bond ratings for institutions of higher learning*. Moody's Investors Service in January 2013 expressed a negative outlook for the entire higher education sector, citing "mounting fiscal pressure on all key university revenue sources." Since 2009, Moody's has been negative on all institutions except well-funded research and highly selective universities.

Positive Forces Impacting Higher Education

In spite of the fact that this discussion has been very negative to this point, the author remains optimistic that most of higher education will draw upon long term strengths as well as new-found innovation and resilience to respond to these trends and forces. Its strengths include:

- **Tradition.** In spite of the growing negative press, there is much residual faith in the value of a college degree.
- **Inertia.** This force will be on their side, although with decreasing impact as the speed of change accelerates.
- **International students.** Numbers of recruitments from other countries are still increasing, but this may not be favorable long-term because other nations are rapidly catching up. (Even a French university is now offering degrees in English.)
- **Brand Loyalty.** It is hard to find customers that are more loyal than many alumni/benefactors.
- **Devotion of faculty and staff.** In addition to the intrinsic rewards of teaching and mentoring students, motivation, pride of accomplishment and longevity are often quite high in this industry.
- **Importance of critical thinking.** There will always be a need and demand for systems to teach critical thinking. This author hopes that many institutions are waking up to the need for teaching values and their vital role in building a strong society through critical thinking and character formation, not just occupational training.
- **Shift from manual labor to knowledge-based society.** This process has a long way to go.
- **Use of technology.** MOOCs and other online learning platforms are having a profound impact among higher education institutions, but it will be an evolutionary shift. There is much more likely to be blended learning, rather than the extremes of all online or all seat time on campus. "Rather than being disruptive to Bowdoin[College], I am convinced that technology and modes of learning emancipated by technology will have the power, potentially, to incrementally, rather than disruptively, improve our educational model," wrote Bowdoin President Barry Mills.
- **Higher education leadership is waking up to the challenge.** Universities are increasingly searching for leadership for change, for business skills, and with a bias for action. Leaders recognize that resource allocations cannot just trim across the board, but that they must shed programs, campuses, buildings, etc. to compete in this new paradigm.
- **Upward mobility through higher education is still true.** Evidence from the U.S. Bureau of Labor Statistics indicates higher education still pays more than the cost.
- **Continuing importance.** Education has been and will continue to be one of the major contributing factors to our prosperity and freedoms.

A Partial List of Recommendations

University leadership must recognize that the institution cannot change the external forces – it can only resist, ignore, or innovate, and the greatest temptation is to ignore. "When we are no longer able to change a situation, we are challenged to change ourselves." Viktor E. Frankl

The focus of this article has been on presenting the indicators and forces which point toward distress for higher education in the U.S. Thankfully, the author was not asked to provide solutions, but in developing this topic for those with restructuring expertise, it is hoped that they will help this industry, not just to survive, but to thrive.

The following recommendations for advisors and decision makers come not only from decades of experience in this industry, but also from decades of devotion to its future viability.

- Identify which forces are benign, positive, negative, or both – and develop strategies to address each of them. Some disruptive forces might be used for benefit (e.g., technology).

- Strengthen the institution's financial reserves – focus on a solid balance sheet.

- Consider unbundling of degrees, and credits from multiple universities.

- Watch for opportunities for needed mergers, but remember that a merger could just delay the inevitable if other factors are not addressed (i.e., a short-term fix). Focus on what to stop doing, and resist the constant pressure to always add new programs and services that are not central to the mission or well-funded.

- Tenure systems must evolve to allow flexibility—it is good to protect faculty against retaliation for new or different ideas, but not good to protect against economic forces and mission changes. In 1975, 75% of faculty members were tenured or on a tenure track; today they represent only 30%.

- Differentiate your institution from the pack, be market sensitive, and demonstrate value.

- Business models must change to maintain core mission in a new environment.

- Dr. E. Gordon Gee, at the February 2009 annual meeting of the American Council on Education, stated, *"Above all, higher education must resist the 'first instinct' to hunker down, hide out, take refuge in the fox hole, and wait for the storm to pass."*

- Elite (i.e., well-endowed) universities will survive this easily, but a large segment of current universities and colleges may not survive if they are not distinctive, have a purpose and a price that is desirable, and adjust to the storms of culture, while protecting and maintaining the central values of education.

Conclusion

Big changes are coming, and old attitudes and business models are set to collapse as new ones rise. Awareness of impact of the external forces and the internal traditions is growing, while still lagging somewhat behind reality. Severe financial contraction and/or adjustment in the higher education industry is on the way.

Nathan Harden expressed a contrarian view in *The End of the University as We Know It*: "But if our goal is educating as many students as possible, as well as possible, as affordably as possible, then the end of the university as we know it is nothing to fear. Indeed, it's something to celebrate."

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