AIRA | Association of Insolvency & Restructuring Advisors

Journal

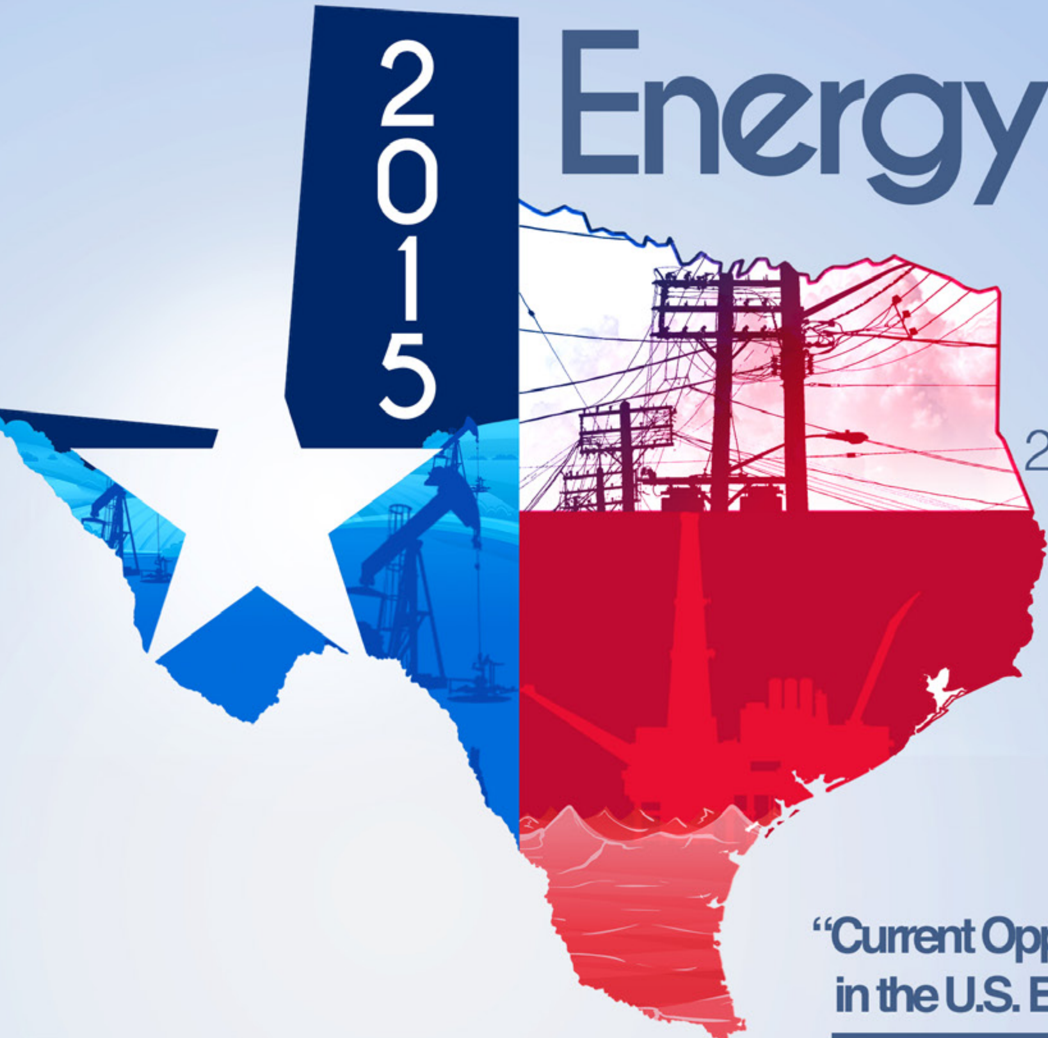
Vol. 29 No. 3 - 2015

SUPREME COURT PROVIDES ANSWER REGARDING EXTENT OF FEDERAL JUDICIARY'S POWERS

By Alan Lepene, Andy Turscak and Jim Henderson

What's Inside:

Energy Summit



September 16, 2015
2:30 - 7:30 PM
Belo Mansion & Pavilion
2101 Ross Ave, Dallas, TX

"Current Opportunities and Challenges in the U.S. Energy Sector"

Join top minds and key players in the energy industry at the 4th Annual Energy Summit, hosted by AIRA and the Southwest Chapter of the Commercial Finance Association. Bankruptcy and restructuring advisors and others will gain valuable insights into current and future energy issues as well as the opportunity to network and make new contacts at a networking reception immediately following.

Keynote Speaker: Dr. Bernard Weinstein, Ph.D.,
Associate Director of the Maguire Energy Institute and Adjunct Professor of Business, Southern Methodist University

Economic Forecast: Dr. E. Nicholas Jones, Ph.D.,
Energy Advisor - Corporate Strategic Planning, ExxonMobil

Corporate Restructuring: A panel on recent corporate restructurings in the energy sector, moderated by **William Snyder,** *Principal and National Leader, Deloitte CRG*

M&A and Financing: A panel on energy sector M&A and financing activity and outlook, moderated by **Albert S. Conly,** *Senior Managing Director – Corporate Finance, FTI Consulting*

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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
Valda Newton - Assistant Editor

THOMAS MORROW, CIRA
AlixPartners, LLP

I would like to introduce myself to AIRA's membership. I am Tom Morrow and am the incoming President of AIRA. I have been with AlixPartners for over 20 years and associated with AIRA for almost as long. I would like to share my thoughts with you on a few key areas.

On taking over as President from Matt Schwartz. What an act to follow! Matt did such great job as President it will be my honor if I can accomplish 80 percent of what Matt did. During his term he led one of the most successful Annual Conferences we have ever had. He also has restructured the committees that AIRA uses to get things done and provided important leadership to the Grant Newton Endowment Fund to keep this important charity growing. Thanks for your many contributions to the Association, Matt!

AIRA's Mission. In addition to "uniting and supporting professionals providing business turnaround, restructuring and bankruptcy services; and developing, promoting and maintaining professional standards of practice, including a professional certification program," the AIRA is about education. We have a lot to offer. Here is a quick list of what is coming up; more information at www.aira.org.

- *CIRA and CDBV classes*. We offer the CIRA courses in New York, California, Puerto Rico and online; CDBV classes in New York and California. See website for specific dates and locations.
- *Energy Summit*. This specialized regional program takes place September 16, in Dallas.
- *AIRA at NCBJ*. AIRA hosts the Opening Reception and a Breakfast Program (on Sunday, Sept. 27 and Tuesday, Sept. 29, respectively). This year's NCBJ is September 27-30, in Miami.
- *New York POR conference*. The 14th edition of this all-day program takes place Nov. 2.
- *32nd Annual Conference*. Plan to join us June 8-11, at the Coronado Island Marriott!

Being a volunteer organization. The AIRA is primarily a volunteer organization. We need your help to create material and serve as panel members for AIRA's educational conferences and other programs throughout the year. AIRA's monthly are an excellent medium for member involvement. We also are currently seeking and highly value member contributions to AIRA Journal.

A small but experienced staff. The work of all the volunteers would not accomplish as much as it does without the support of AIRA's staff in Medford, Oregon. This group makes AIRA their passion and they are the glue that holds everything together – more on this talented group in future articles.

MEET AIRA'S NEW PRESIDENT

At the close of AIRA's 31st Annual Conference in Philadelphia, Tom Morrow, CIRA, assumed the responsibilities of President, following Matthew Schwartz, CIRA, who now serves as Chairman. Tom has been a member of AIRA for over 20 years, a Director for 10 years, and active in many roles including Vice President for CIRA and CDBV, and Co-Chair of the 24th Annual Conference in Las Vegas. He received his CIRA certificate in 1998.

Tom has spent more than 20 years at AlixPartners helping companies solve financial and strategic challenges. At AlixPartners he has held the position of Managing Director and his work has focused on helping companies improve profitability through better management of their cash flow, cost structure and human resources. He provides expertise in financial, operational and business analysis; loan workouts and restructurings; and creditor negotiations. Prior to joining AlixPartners, Tom was Director of Franchise with Wendy's International where he was responsible for franchisee restructurings. At present, Tom continues working on the General Motors bankruptcy case as Trustee for one of the trusts that is resolving certain legacy assets.

Tom holds a BBA with distinction from the University of Michigan and an MBA from the University of Chicago. He is a Certified Turnaround Professional and active member of the American Bankruptcy Institute, serving on ABI's board for 2 ½ years. He is also a frequent speaker and author on restructuring topics.

AIRA @ NCBJ

September 27-30, 2015
Fontainebleau Miami Beach

Opening Reception

September 27, 5:30-7:30pm

AIRA will again host the Opening Reception of the 89th Annual National Bankruptcy Judges' Conference, open to all participants and guests registered for the conference. Attendance at the NCBJ 2015 is expected to exceed 2,000. Additional sponsor slots may still be available - contact Cheryl Campbell at ccampbell@aira.org.

Breakfast Program

September 29, 7:00-8:45am

"What's New in Mass Tort Cases?"

The subject matter presented will be on recent developments in tort cases centering on New England Compounding and the railroad derailment in Canada.

Moderator: Stephen B. Darr, CIRA, CDBV, *Managing Director, Huron Business Advisory*

Speakers: Robert J. Keach, *Shareholder, Bernstein Shur*

Michael R. Lastowski, *Managing Partner, Duane Morris*

Harold B. Murphy, *Shareholder, Murphy & King*

Breakfast Registration
Online at www.aira.org

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Deloitte.

Deloitte CRG is a leader in helping organizations transform periods of financial difficulty or crisis into opportunities for rejuvenation. Having led both large multinational organizations and mid-market companies through unprecedented challenges, we apply our unrivalled experience and superior foresight to achieve successful outcomes for our clients, their creditors, and equity holders. Whether the goal is to enhance the performance of a healthy company, assume an interim leadership role, or guide stakeholders through complex bankruptcy reorganization, our team works closely with the client to quickly understand their business and most pressing issues and then advise them on how to move ahead with confidence.

EY Building a better working world

At EY, we are committed to building a better working world — with increased trust and confidence in business, sustainable growth, development of talent in all its forms, and greater collaboration.We want to build a better working world through our own actions and by engaging with like-minded organizations and individuals. This is our purpose — and why we exist as an organization.Running through our organization is a strong sense of obligation to serve a number of different stakeholders who count on us to deliver quality and excellence in everything we do. We want to use our global reach and scale to convene the conversation about the challenges facing economies and the capital markets.

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Friedman LLP has been serving the accounting, tax and business consulting needs of public and private companies since 1924. Our clients benefit from hands-on contact with our partners, cutting-edge technical expertise and our understanding of their industry and their business. Our Corporate Recovery Services (CRS) group offers specialized services to debtors, creditors, trustees and other parties-in-interest involved in various bankruptcy and insolvency situations. Friedman's professionals have specific expertise in turnaround management, bankruptcy and restructuring, advisory services for distressed companies, creditors, trustees and other stakeholders.

Huron Business Advisory

Huron Business Advisory resolves complex business issues and enhances value. We offer a full suite of services in key areas, including forensic investigations, transaction advisory, restructuring and turnaround, interim management, capital raising, operational improvement, and valuation. Our senior-level team members have vast experience in a range of industries, with many serving as C-level executives, so we can quickly analyze a business situation and apply our knowledge to finding a workable solution. With this breadth of expertise, we can drive improvement at middle-market companies and larger businesses and apply flexible staffing models to deliver the best possible outcome for our clients.

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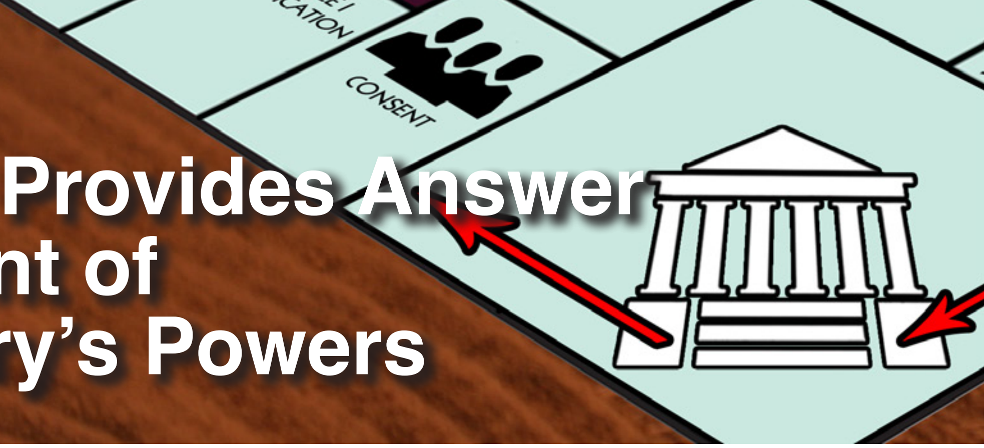
FEATURE ARTICLE



Supreme Court Provides Answer Regarding Extent of Federal Judiciary's Powers

ALAN R. LEPENE, ANDY TURSCAK and JIM HENDERSON
Thompson Hine LLP

A divided Supreme Court issued its third decision in four years regarding bankruptcy court authority, holding that a bankruptcy court may, in fact, enter a final order on a matter that would otherwise require final disposition by an Article III judge — if all parties consent.

In *Wellness International Network, Ltd. v. Sharif*,[1] the Court finally resolved the doubt and confusion surrounding the jurisdictional authority of bankruptcy and magistrate judges that arose out of its previous decisions in *Stern v. Marshall*[2] and *Executive Benefits Insurance Agency v. Arkison*.[3] The *Wellness International* decision affirms that parties may consent, either expressly or implicitly, to a final judgment by an Article I court on a matter the court might not otherwise possess constitutional authority to decide.

The majority opinion — while navigating a minefield of constitutional and practical considerations — preserves and reaffirms the authority of the federal magistrate and bankruptcy court systems.

To provide context for the significance of *Wellness International*, a summary of relevant events of the last four years is in order, starting with the Court's decision in *Stern*.

The Uncertainty Arising out of *Stern*

The Supreme Court's 2011 decision in *Stern* raised significant, fundamental questions regarding the permissible roles of federal bankruptcy judges and — by extension — federal magistrate judges.

In *Stern*, the Court examined the scope of judicial authority conferred upon courts under the Constitution. Under 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]

In contrast, Congress created 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. In *Stern*, the Court held 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 claim designated by Congress 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 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. A number of lower courts stepped in to address that question.

The Post-*Stern* Circuit Split

In *Stern's* aftermath, a number of courts weighed in on the consent question, including, among others, the Sixth, Seventh, and Ninth Circuit Courts of Appeals, creating a circuit split on the issue.

Ninth Circuit (*Executive Benefits*)

The Ninth Circuit Court of Appeals held that a party may consent to a bankruptcy judge entering a final order on a matter that,

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1 *Wellness International Network, Ltd. v. Sharif*, 575 U.S. ___ (2015) ("*Wellness International*").

2 564 U.S. ___; 131 S. Ct. 2594 (2011) ("*Stern*").

3 573 U.S. ___ (2014) ("*Executive Benefits*").

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 *See* 28 U.S.C. § 157(b)(2). 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.

absent consent, would require final adjudication by an Article III judge.[8] The court observed that the concerns expressed in *Stern* regarding differences between Article III and Article I courts involved primarily the protection of personal, rather than structural, interests. Also, citing fears with tactics of litigants who might delay in raising an objection to a final determination being made by a bankruptcy judge, the Ninth Circuit 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 panel held that a party could 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 lacked constitutional authority to enter final orders on matters before them. The issue arises under 28 U.S.C. § 157, pursuant to which Congress conferred authority upon the bankruptcy courts to enter final orders on all "core" matters 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*, 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 claims. 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.

Sixth (*Waldman*) and Seventh (*Wellness International*) Circuits

Just before the Ninth Circuit issued its decision, the Sixth Circuit, in *Waldman v. Stone*,[9] also confronted the question of whether parties to a lawsuit could 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, the bankruptcy court could not enter a final order on the plaintiff's affirmative claims, notwithstanding the defendant's explicit consent.

Needless to say, the Ninth Circuit's decision a short time later created a circuit split on the consent question, which only widened with a number of other courts also taking sides. Most notably, in *Wellness International Network, Ltd. v. Sharif*,[10] the Seventh Circuit Court of Appeals aligned with the Sixth Circuit in holding that consent by the parties is insufficient to overcome the structural framework of Article III.

The Seventh Circuit's *Wellness International* decision would eventually make its way to the United States Supreme Court.

However, the Ninth Circuit's *Executive Benefits* decision arrived there first.

Executive Benefits

To the surprise of many, in *Executive Benefits*, the Supreme Court declined to decide the consent issue. Instead, it laid down the procedure that must be followed by a bankruptcy court when addressing a so-called "Stern Claim."

The Court resolved the issue of the supposed "statutory gap" by explaining the plain text of the statute operates to close the gap. Because it 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.

Notably, while resolving the statutory gap, 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.

In dodging the primary issue causing the circuit split, the Court applied a Band-Aid fix to the question of the extent of the bankruptcy courts' constitutional adjudicative authority, leaving the fundamental question of consent unanswered — but not for long.

In fact, only weeks after its *Executive Benefits* decision, the Court accepted review of 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 constitutional proscriptions. The Court agreed to take up the ultimate consent question in *Wellness International*; it also agreed to consider whether — assuming consent is effective to overcome any constitutional prohibition — implied consent would also be sufficient to satisfy Article III of the Constitution.

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

9 698 F.3d 910 (6th Cir. 2012).

10 727 F.3d 751, 771 (7th Cir. 2013).

11 *Executive Benefits Insurance Agency v. Arkison*, 573 U.S. ___ (2014). *See also* 28 U.S.C. § 157(c).

Wellness International

In *Wellness International*, the 6-3 majority (led by Justice Sotomayor) answered both questions in the affirmative. The Court began its analysis with the proposition that adjudication by consent is "nothing new." In support of this proposition, the Court surveyed a number historical precedents confirming the propriety of arbitrator adjudications upon consent of the parties, as well as judgments by federal magistrates with the parties' consent and judgments entered by other "Article I adjudicators."

The Court reaffirmed that Article III does indeed serve a structural, separation of powers purpose — *i.e.*, to bar efforts by Congress to transfer jurisdiction to non-Article III tribunals for the purpose of "emasculating" Article III courts. But the Court also explained that this structural purpose is not offended by allowing parties to consent to adjudication of Stern Claims by bankruptcy judges. This is so in part because there was no indication Congress enabled bankruptcy courts to decide Stern Claims as part of an effort to "humble" the Article III judiciary.

Moreover, Article III judges retain ultimate control over bankruptcy judges (and magistrate judges), by virtue of, among other things, the fact that bankruptcy judges (like magistrate judges) are appointed by — and subject to removal by — Article III judges. For all these reasons, the majority concluded that adjudication of Stern Claims by bankruptcy judges poses no threat to judicial integrity or separation of powers doctrine when the parties consent to such judgments.

In addition, the Court held that such consent need not be express, as long as it is knowing and voluntary (on this point, Justice Alito concurred in judgment only, stating that the Court did not need to reach the question of whether consent may be implied). The Court did caution, however, that it is good practice for courts to seek express statements of consent or non-consent; it also noted that statutes or rules may include an express consent requirement even though the Constitution does not require consent to be explicit.

The dissenting justices (led by Chief Justice Roberts) argued that the Court could have decided the case without reaching the consent question. Instead, according to the dissent, the decision inappropriately allows parties to consent to constitutional violations implicating profound separation of powers concerns on pragmatic grounds. The dissent cautioned that convenience and efficiency are not sufficient considerations to cure constitutional violations. It also warned that the majority established a precedent for Congress to further encroach on the judicial power of Article III courts in the future.

Undoubtedly, as the dissent points out, the Court majority was motivated to consider and resolve the consent question, at least in part, by the fact that the rationale for *Stern* and *Executive Benefits* had implications for the federal judiciary beyond the bankruptcy system.

Indeed, in addition to the weighty constitutional analysis involved, a recurring theme of the majority opinion was the practical effect of a determination that Article I judges could not decide most matters even with the consent of the parties. The majority noted that Article I bankruptcy and magistrate judges together actually outnumber Article III circuit and district judges. And bankruptcy case filings far exceed the number of cases filed in district and circuit courts. As the Court observed, without the distinguished service of bankruptcy and magistrate judges, the federal court system "would grind nearly to a halt."

The Supreme Court's 2011 *Stern* decision ignited a four year debate among the lower courts regarding the extent of authority held by bankruptcy and other Article I judges.

Its 2015 *Wellness International* decision guided the debate to an abrupt conclusion, unequivocally answering the question that had caused a great deal of uncertainty regarding the future roles of bankruptcy and magistrate judges within the federal judiciary. In the wake of *Wellness International*, it is now clear that if the parties consent, Article I courts may hear and enter final judgments on matters that would otherwise require final disposition by Article III judges.

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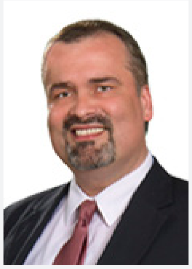

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RECENT CASES

Validity of Appraisal Arbitrage Affirmed in Delaware

One of the more hotly debated issues in and out of Delaware Chancery Court recently has been the legitimacy of appraisal arbitrage. In brief, the practice of appraisal arbitrage, first upheld by the 2007 decision of the Court in *In Re Appraisal of Transkaryotic Therapies, Inc.*, entails the purchase of shares of the target, most often in a cash-out merger, by an investor, after the record date, but before the deal has closed, perfecting his or her appraisal rights by not voting in favor of the transaction, and in turn, filing a petition to have the fair value of the shares appraised by the Court in the expectation of realizing a return (including interest) in excess of the deal price.

Legal practitioners opposed to appraisal arbitrage have argued in essence that it undermines the statutory aim of investor protection. To this end, in follow-up to the legislative proposal submitted to the Delaware Bar Association's Corporation Law Section on the subject of appraisal under Delaware General Corporation Law, Section 262, a group of corporate law firms comprised of Cravath, Swaine & Moore LLP, Davis Polk & Wardwell LLP, Latham & Watkins LLP, Skadden, Arps, Slate, Meagher & Flom LLP, Simpson Thacher & Bartlett LLP, Sullivan & Cromwell LLP and Wachtell, Lipton, Rosen & Katz opined in a letter to the Council of the Corporate Law Section of the Delaware State Bar Association that the legislation does not do enough to address the negative impact of appraisal arbitrage. In particular, the letter stated: that

> "We believe that strong equitable arguments can be made to deny appraisal rights to anyone purchasing after public announcement of a transaction, but at a minimum there is no justification for permitting holders who purchased their shares after the record date for the vote to seek appraisal as if they were dissenters. This approach would fulfill the legislative purpose of protecting stockholders of Delaware corporations who dissent from a merger that is subject to appraisal rights. It would also reduce the unseemly claims-buying that is rampant and serves no legitimate equitable or other purpose, but threatens to undermine transactional certainty and reduce value to shareholders of Delaware corporations as acquirers, particularly in leveraged transactions, may be forced to factor the enhanced appraisal risk into their calculations."

Two recent decisions by the Delaware Court of Chancery, *In re Appraisal of Ancestry.com*, Consol. C.A. No. 8173-VCG (Jan. 5, 2015) and *Merion Capital v. BMC Software*, C.A. No. 8900-VCG (Jan. 5, 2015), have found otherwise, however. The same is true of the Council of the Corporation Law Section of the Delaware State Bar Association, which after extensive study, chose not to curtail the strategy.

The opinion by Vice Chancellor Glasscock in Ancestry.com is the first since the Delaware appraisal statute was amended in 2007 to decide whether the Court's ruling in *Transkaryotic* would remain relevant law given the amendment. In doing so, the Court rejected Ancestry's arguments that since the amendment allows for beneficial owners to petition for appraisal of their shares directly, a beneficial owner must show that its predecessors did not vote to approve the merger. Otherwise, the beneficial owner lacks standing.

The Court concluded, rather, that under a plain reading of the statute, it is the record holder alone that must have no-voted the shares for which it seeks appraisal by the Court, and that the statute does not require the stockholder to show that previous owners also refrained from voting in favor. Moreover, the Court found Ancestry's proposed share-tracing requirement to be invalidated by *Transkaryotic*. Accordingly, the Court declined to adopt Ancestry's proposed share-tracing requirement, and denied the company's motion for summary judgment.

Similarly, in *Merion Capital v. BMC Software*, BMC challenged Merion's standing arguing that Merion had to prove that each share for which it sought appraisal was not voted in favor of the merger by any previous owner. As in *Ancestry.com*, however, the Court rejected BMC's challenge, observing that nothing in the statute requires a stockholder to prove that the specific shares for which it seeks appraisal were not voted in favor of the merger. And in denying BMC's Motion for Summary Judgment, the Court held that (1) Merion had made a written demand for appraisal on a date when it owned all of the shares for which it demanded an appraisal, (2) Merion's demand for appraisal was timely and informative, (3) after delivering its demand, Merion continued to own the shares through the effective date of the merger, and (4) Merion never voted any of the shares for which it sought appraisal in favor of the merger.

Formed in response to critics of appraisal arbitrage seeking to propose legislative changes to Section 262 of the Delaware General Corporation Law that would limit the practice, the Council of the Corporation Law Section of the Delaware State Bar concluded after extensive review that the statute should not limit appraisal rights to shares held before the public announcement of a merger. Among other factors, the findings of the Council include that (1) since 1989, Delaware law has recognized the right of a shareholder to petition for the appraisal of shares purchased after the terms of the merger were announced, (2) arm's-length deals with adequate market checks do not create appraisal risks for buyers, (3) fiduciary duties and litigation may not be enough to ensure that the merger price reflects the fair value of the shares in transactions not subject to a market check, (4) in 2013 only 17% of the appraisal eligible transactions in Delaware led to appraisal litigation, and (5) appraisal cases self-select, and mainly involve conflict transactions, whereas non-conflict transactions are less in number and often result in appraisals below or near the merger price.

Keywords: appraisal rights, appraisal arbitrage, fair value, litigation, Delaware General Corporation Law, Delaware Chancery Court

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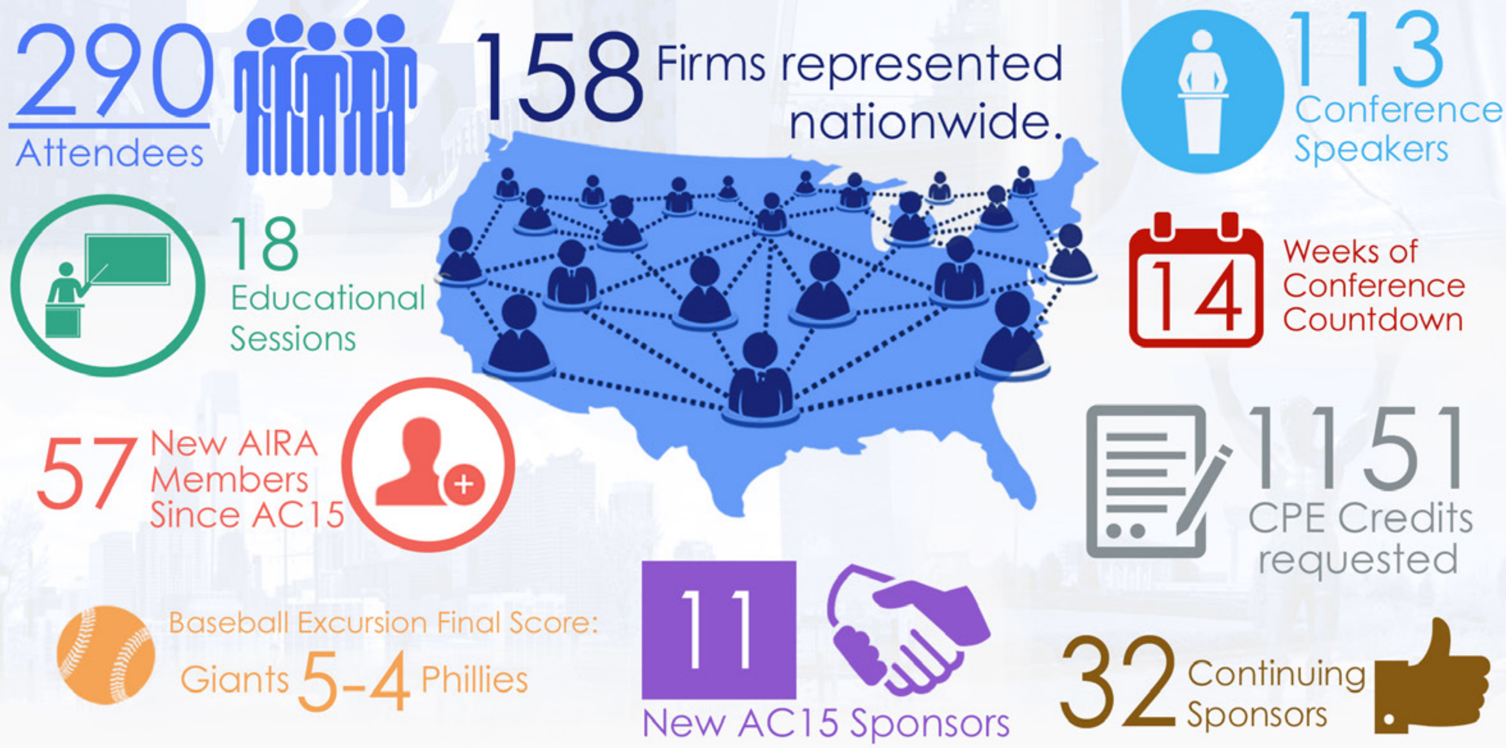

Walter Greenhalgh Receives 2015 Manny Katten Award

Walter J. Greenhalgh, a Managing Partner with Duane Morris LLP, was honored with the 2015 Manny Katten Award at AIRA's Annual Banquet on Thursday, June 4 at The Ritz Carlton Philadelphia. Mr. Greenhalgh has been a steady source of leadership and support within the AIRA since he joined in 2004; as well as playing an influential and active role in the broader community of bankruptcy and restructuring for many years.

Walter Greenhalgh, Managing Partner, Duane Morris LLP, receives his award from Michael Lastowski (Duane Morris LLP) and Hon. Rosemary Gamberdella (U.S. Bankruptcy Court, D NJ)

Mr. Greenhalgh's leadership in AIRA has been especially significant in the success of AIRA's Advanced Restructuring and Plan of Reorganization (POR) Conference, held annually in New York since 2002. From 2009 to the present, he has served as moderator and speaker, member of the planning committee (2011-2015), and co-chair (2012-2015). He is currently involved in preparation for the 14th POR Conference, taking place on November 2, 2015. He has also served as moderator and panelist at AIRA's annual conferences.

Mr. Greenhalgh is the managing partner of Duane Morris' Newark office and a member of the firm's national governing Partners Board. He practices in the areas of commercial litigation and bankruptcy law, insolvency law, and chapter 11 corporate and commercial reorganization. His distinguished record includes past chair of the executive committee of the Bankruptcy Law Section of the New Jersey State Bar Association (officer of the Section for more than ten years); and a founding master of the Bankruptcy Inn of Court established in memory of Judges Vincent J. Commisa, D. Joseph DeVito and Daniel J. Moore (one of two Inns of Court dedicated to bankruptcy practice in the United States).

2015 ZOLFO COOPER AWARDS

Medals for the Zolfo Cooper Awards and Certificates of Distinguished Performance were conferred upon candidates who earned the top composite scores for all three parts of the CIRA exam completed by end of the previous year. John Boken, Senior Managing Director, presented the awards on behalf of Zolfo Cooper.

GOLD MEDAL

Meghan Grant
Manager, Protiviti Inc.
Baltimore, MD

SILVER MEDAL

Michael Hamilton, CIRA
Independent Consultant, MMC Energy
Maywood, NJ

BRONZE MEDAL

Jeffrey Beard, CIRA
Managing Director, Huron Business Advisory
Troy, MI

DISTINGUISHED PERFORMANCE

Mark Iammartino
Managing Director, MorrisAnderson
Chicago, IL

Chris Hebard
Senior Associate, Deloitte CRG
Dallas, TX

Mahtab Khalili, CIRA
Manager, Deloitte CRG
New York, NY

Jason Rae, CIRA
Shareholder, Lain, Faulkner & Co., PC
Dallas, TX

Passing the Torch: Grant Newton Announces Retirement in 2016

After presentation of the Zolfo Cooper and Manny Katten Awards at the annual banquet, outgoing President Matthew Schwartz took the podium to announce the retirement of Grant Newton at the end of the year. Serving on planning committees and as a speaker for AIRA events from its inception, Grant has played a key role in the development and implementation of the CIRA and CDBV programs and as the Association's President and Executive Director over a period of 30+ years, teaching most of the CIRA and CDBV courses. Grant's successor was also announced to the room full of attendees at the Annual Banquet: Thomas Morrow, of AlixPartners, LLP. Tom will assume his new role as of January 1.

From left to right: Matthew Schwartz (Bederson LLP), Anthony Sasso (Deloitte) and Thomas Morrow (AlixPartners) express appreciation to Grant Newton for his many years of service to AIRA.

Bankruptcy Taxes

PETER ENYART, SECTION EDITOR
McGladrey LLP

Bankruptcy Section 363 Asset Sale Tax Consequences

By Peter Enyart

In the recent years following the economic downturn, bankruptcy law has helped many corporations to reorganize their finances. Section 363 of the Bankruptcy Code (a "Section 363 Sale") provides a process to efficiently sell assets and satisfy debt obligations. A corporation that undertakes a Section 363 Sale must plan for the tax consequences of the sale.

Reorganizing under bankruptcy may be structured as a taxable or nontaxable transaction. Surprisingly, a nontaxable transaction is not always more advantageous than a taxable transaction. The more advantageous transaction is dependent on the taxpayer's facts and circumstances, but taxable or nontaxable treatment is not elective. The tax treatment of the transaction will be determined based on the form and substance of the transaction. This article focuses on identifying differences between taxable and nontaxable Section 363 Sales when reorganizing in bankruptcy (or a similar case) and how various facts and circumstances may impact the related tax consequences.

Bankruptcy Code Section 363

A Section 363 Sale provides a process for distressed corporate debtors to sell assets outside the ordinary course of its business. Corporations in bankruptcy frequently use Section 363 Sales to sell assets free and clear of all liens.[1] The sale may include specific assets or substantially all of a corporation's business assets. Which assets are sold is generally dependant on how the corporation plans to operate upon completion of the reorganization. However, before a Section 363 Sale may take place, the sale must be approved by a bankruptcy court.

A bankruptcy court may grant approval for a Section 363 Sale over the objections of the corporate creditors and shareholders, presuming the judge is presented "a good business reason"[2] for doing so. There are a multitude of relevant factors which may drive the judge's decision. One factor in favor of executing a Section 363 Sale is to expedite the reorganization process while also providing the bankruptcy estate the most value with the least amount of expense. Once approved, the sale order becomes effective and the sale is completed. Following the sale, any liens would generally attach to the proceeds and would be satisfied by the bankruptcy estate.[3] Section 363 Sales have been used frequently in recent major bankruptcy reorganizations, including General Motors ("GM") and Lehman Brothers Holdings, Inc ("Lehman Bros.").

Most Section 363 Sales are structured as taxable asset sales. That was the outcome of the Lehman Bros. transaction. Typically, the debtor corporation sells its assets to a newly formed entity owned by the creditors. The assets are transferred in exchange for some combination of cash, assumption of certain liabilities or both and the corporation recognizes gain or loss. However, the sale can also result in a tax-free treatment as a "G" reorganization under Internal Revenue Code ("IRC" or "Code") Section 368(a)(1)(G) if certain conditions are met. The result is not elective. The structure of the transaction will dictate whether it is taxable or not. A more in depth discussion of the conditions and consequences of a "G" reorganization will be discussed below, but first we will analyze the effect of a taxable transaction.

Taxable Asset Sales

Most Section 363 Sales are structured as a taxable asset sales where the distressed corporation ("LossCo") sells assets to its creditors in exchange for LossCo debt as a part of an overall plan of reorganization in bankruptcy. The assets are then contributed by the creditors to a newly formed entity ("NewBiz"). LossCo recognizes gain or loss based on the difference between each asset's relative fair market value and tax basis, and the creditors will get a cost basis in each asset equal to the fair market value of the asset. Based on the value of the assets, this may result in a step-up (or step-down) in the basis of the assets. A transaction that results in a stepped-up asset basis is favorable since it will likely provide for increased amortization and depreciation deductions over the tax life of intangible and depreciable assets. NewBiz will commence its operations following the reorganization and LossCo will liquidate.

LossCo may have significant net operating losses (NOLs) and other tax attributes that can shelter income from income taxes. A reorganization in bankruptcy will often result in an "ownership change" under IRC Section 382 when the creditors obtain ownership of the business. For purposes of IRC Section 382, an ownership change occurs when there has been a more than 50 percent change in ownership over a three-year period.[4] An ownership change can greatly reduce or eliminate any benefit the NOLs will provide post reorganization.[5] As a result, one tax strategy is to structure a taxable sale so LossCo recognizes gain when it has the NOLs and other tax attributes to shelter the resulting income tax. Following the reorganization, the creditors

1 BC Section 363(f).
2 *In re Lionel Corp.*, 722 F. 2d 1063 (2d Cir. 1983).
3 BC Section 363(e).

4 IRC Section 382(g).
5 However, some Title 11 of the U.S. Code bankruptcies may not be subject to a Section 382 limitation if the requirements of Section 382(l)(5) are met.

do not succeed to the NOLs and other tax attributes. However, the limitations under IRC Section 382 likely would have reduced the benefit of the NOLs and tax attributes. Thus, NewBiz is able to obtain a stepped-up in basis in the assets and LossCo is able to shelter gain with the NOLs and tax attributes.

Indebtedness that is forgiven (cancellation of debt or "COD") in bankruptcy is excluded from gross income under the bankruptcy exception of IRC Section 108(a)(1)(A). LossCo's NOLs and tax attributes are generally reduced to the extent of the excluded income.[6] However, the NOLs and tax attributes would not carryover to NewBiz in a taxable asset sale. Therefore, any NOL and tax attribute reductions due to COD are of little concern to either entity in a taxable asset sale.

Non-Taxable "G" Reorganization

Alternatively, LossCo could transfer its assets to NewBiz tax-free in a "G" reorganization, if certain conditions are met. For example, the GM Section 363 Sale was structured as a tax-free "G" reorganization. In these transactions, LossCo and NewBiz recognize no gain or loss on the asset transfer.[7] The acquiring entity, NewBiz, takes a carryover basis in the corporate assets[8] and succeeds to the NOLs and tax attributes subject to limitations and restrictions.[9] The NOLs and tax attributes are generally reduced to the extent of COD income excluded by LossCo.[10] The utilization of any remaining NOLs and tax attributes may be limited or eliminated completely as a result of the ownership change under IRC Section 382 unless the requirements of IRC 382(l)(5) are met.

The definition of a "G" Reorganization under IRC Section 368(a)(1)(G) is a transfer by a corporation of all or part of its assets to another corporation in a Title 11of the U.S. Code ("Title 11") or similar case; but only if, *in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed* in a transaction which qualifies under IRC Sections 354, 355, or 356.

Additional nonstatutory conditions required for a "G" reorganization include:

1. The transferor corporation (LossCo) must transfer substantially all of its assets to the acquiring corporation (NewBiz).[11] The Internal Revenue Service (the "Service") has ruled that the substantially all requirement was met where the acquiring corporation received more than 50% of the fair market value of the gross assets held by the transferor and more than 70% of the fair market value of the operating assets held by the transferor.[12]

2. The continuity of proprietary interest ("COI") requirement must be met. COI requires that the shareholders of transferor company (LossCo) receive a substantial equity interest in the acquiring corporation (NewBiz). In a bankruptcy, the creditors are the true economic owners of the equity of an insolvent corporation. Therefore, when LossCo's assets are transferred in a bankruptcy case, the creditors generally should be considered the shareholders of LossCo for "continuity" purposes.[13] An example in the regulations suggests that 40% stock continuity is sufficient to satisfy the continuity of interest requirement.[14]

3. The continuity of business enterprise ("COBE") requirement must be met. COBE requires that the acquiring corporation (NewBiz) either (i) continue a "significant" historic business of the acquired corporation (LossCo), or (ii) use a significant portion of the acquired historic business assets in a business ("asset continuity").

4. The transaction must have a nontax business purpose.[15]

5. The entities must be a "party to the reorganization."[16] Simply put, the transferor company (LossCo) and the acquiring company (corporation) must be corporations.

Presuming the required conditions are met, the primary advantages of a "G" reorganization are that assets are transferred tax-free and LossCo's NOLs and other tax attributes carryover to NewBiz, although the utilization of these NOLs may be limited under IRC Section 382. When the newly reorganized business emerges from bankruptcy, its financial condition will undoubtedly be stronger. The availability of NOLs and tax attributes to reduce the tax burden on income earned post bankruptcy may be a significant benefit to consider. However, the disadvantage is that the there is no step-up in the basis for the transferred assets and the utilization of NOLs and tax attributes may be limited.

NOLs and Other Tax Attributes

For purposes of comparing a taxable sale to a nontaxable "G" reorganization for a corporation in bankruptcy, it is crucial to understand that NOLs and other tax attributes only carryover when the transaction is nontaxable. When the transaction is nontaxable, the NOLs and attributes do carryover but their utilization may be limited or eliminated. Therefore, any discussion of attribute elections or the benefit of tax attributes within this section assumes the transaction was a nontaxable "G" reorganization.

IRC Section 382 provides a limitation (the "Section 382 Limitation") on the use of NOLs and other tax attributes when there is an "ownership change." The limitation is generally computed by multiplying the value of the old loss corporation by the long-term tax-exempt rate published by the Service.[17] For purposes of IRC Section 382, an ownership change occurs when there is a more than 50 percent change in ownership over a three year period.[18] As previously stated, a bankruptcy reorganization will often result in an "ownership change" when the creditors obtain ownership of the business. Since an insolvent corporation has no value, the general computation of the Section 382 Limitation could eliminate any benefit from the utilization of NOLs and other tax attributes (i.e., zero multiplied by any rate will result in a zero limitation).

Fortunately, a corporation in bankruptcy under Title 11 (or a similar case) may retain benefits from NOLs and tax attributes if certain conditions are met under IRC Sections 382(l)(5) and 328(l)(6). While an in-depth analysis of these two provisions is

6 IRC Section 108(b).
7 IRC Sections 361, 1032.
8 IRC Section 362(b).
9 IRC Sections 381(a)(2), 381(c).
10 Treas. Reg. Section 1.108-7(c).
11 IRC Section 354(b)(1)(A).
12 See IRS Letter Ruling 201025018; IRS Letter Ruling 9409037; IRS Letter Ruling 9313020; IRS Letter Ruling 9229039; IRS Letter Ruling 8909007; IRS Letter Ruling 8521083; IRS Letter Ruling 8503064.
13 See S Rept No. 96-1035 (PL 96-589) p. 36-37; IRS Letter Ruling 8503064.
14 Treas. Reg. Section 1.368-1(e)(2)(v)(example 1).
15 Treas. Reg. Section 1.368-1(b).
16 IRC Section 368(b).
17 IRC Section 382(b)(1). The Section 382 limitation can be increased for recognized built-in gains under IRC Section 382(h)(1)(A).
18 IRC Section 382(g).

beyond the scope of this article, we will provide a brief summary of these provisions.

First, IRC Section 382(l)(5) completely removes any IRC Section 382 Limitation, but at the cost of (i) a complete limitation of the utilization of NOLs and other tax attributes for a second ownership change that occurs during the two-year period following the change in ownership[19] and (ii) by reducing NOLs carried forward from the three-year period before the ownership change by the deductions taken for interest paid or accrued on debt exchange for stock.[20] The uncertainty surrounding the occurrence of a second ownership may be too significant for IRC Section 382(l)(5) to be a viable option and NewBiz can elect not to have IRC Section 382(l)(5) apply to a change in ownership.[21]

Second, if IRC Section 382(l)(5) does not apply to a "G" reorganization, Section 382(l)(6) may provide for an increase in the Section 382 Limitation. Since the stock of an insolvent corporation typically has no value, any Section 382 Limitation calculated based on the value of the stock of the insolvent corporation could yield a complete limitation of the utilization of NOLs and other tax attributes. However, IRC Section 382(l)(6) computes the limitation immediately after the ownership change and takes into account the increase in value of the corporation attributable to COD, not to exceed the value of the assets before the ownership change.[22] This alternative approach provided by IRC Section 382(l)(6) may establish a limitation that will exceed zero. As a result, these two provisions provide opportunity for certain corporations to retain benefits from the NOLs and tax attributes following an ownership change in bankruptcy.

Overlap Provisions, "G" Reorganizations Take Precedence

On the other hand, a "G" reorganization is not an elective provision. IRC Section 368(a)(1)(G) is a statutory provision of the Code supported by Treasury Regulations and case law. If a transaction falls within its definition and meets nonstatutory requirements, it will be classified as such. Taxpayers that intend to structure a Section 363 Sale as a taxable transaction must insure that at least one "G" reorganization requirement is not met. Often a sale may look as if it is a taxable transaction, but, in substance, it may be a "G" reorganization. Additionally, in the case of overlap with other types of reorganizations (or with IRC Sections 332 or 351), a "G" reorganization is provided exclusive jurisdiction over the transaction.[23]

Illustrating Example and Discussion

LossCo is in Bankruptcy Court and will reorganize under Title 11. LossCo's major creditor, Creditor Z, will form a new corporation (NewBiz) by transferring its LossCo note to NewBiz for 100% of its common stock. NewBiz will purchase substantially all of LossCo's assets in exchange for the note in a Section 363 Sale. Pursuant to the plan approved by the court, LossCo will liquidate following the exchange. All other creditors of LossCo, as well as the former LossCo shareholders, will receive no consideration. Is this example a taxable asset sale or a "G" reorganization? The answer may not be clear.

Perhaps the transaction in the example was structured with the intention of the court, LossCo and Creditor Z that the transaction would be classified as a taxable asset sale. However, the requirements of a "G" reorganization appear to have been met and the transaction may qualify as a tax-free "G" reorganization. However, it is unclear whether stock of NewBiz was distributed in a transaction which qualifies under IRC Sections 354, 355, or 356 even though the transaction resulted in Creditor Z owning the stock of NewBiz. Whether substance or form controls the transaction is perhaps unsettled.

Let's change the facts in this example and assume that NewBiz is a limited liability company (LLC) classified as a partnership for federal taxes. Under this set of facts the transaction does not qualify as a "G" reorganization and will qualify as a taxable asset sale because the transfer was not to a corporation.

Let's change the facts in this example again and assume that the LLC elects to be treated as a corporation. Under what set of facts would the LLC be respected as a "party to the reorganization?" The answer again is not entirely clear. What is clear is that tax planning is an essential element when structuring reorganizations to insure these types of uncertainties are addressed and well documented in support of the transaction's intended result.

Conclusion

A Section 363 Sale is a common tool used by distressed corporations in bankruptcy to reorganize their debt. Frequently these sales are structured as taxable asset sales but can also be nontaxable "G" reorganizations if the required conditions are met. These provisions are not elective so an understanding of the income tax rules is vital to achieve the transaction's desired result. Whether a transaction will be respected as a taxable asset sale or "G" reorganization will have significant income tax implications as the business emerges from bankruptcy. Taxpayers need to consult their tax advisers to make sure any contemplated transactions will satisfy their tax goals based on their unique facts and circumstances.

IRS Rejects Tax Court Position on COD Income Exclusion

By Peter Enyart

The Internal Revenue Service has announced[24] that it will not follow (i.e., the Service nonacquiesced to) four taxpayer-friendly Tax Court decisions, each holding that partners could exclude from gross taxable income their share of the partnership's cancellation of indebtedness income ("CODI") related to indebtedness that was discharged by the bankruptcy court in a Title 11 case. The Service's announcement provides that IRC Section 108(a)(1)(A) bankruptcy CODI exclusion is available only to the taxpayer who commences the proceedings in the bankruptcy court. As a result, it is the Service's position that the CODI exclusion was not available to the partner because it was the partnership that was the debtor under the terms of the Bankruptcy Code.

In each Tax Court case, a general partner that had guaranteed its partnership's debt was released from all liability as a result of a discharge granted by the bankruptcy court to the partnership in a Title 11 case. *See Estate of Martinez v. Commissioner*, T.C. Memo. 2004-150; *Gracia v. Commissioner*, T.C. Memo. 2004-147; *Mirarchi v. Commissioner*, T.C. Memo. 2004-148; *Price v. Commissioner*, T.C. Memo. 2004-149.[25] Although certain exclusion rules are to be applied at the partner level per IRC Section 108(d)(6), the court found the partners to be "under the jurisdiction of the

19 IRC Section 382(l)(5)(D).
20 IRC Section 382(l)(5)(B); Treas. Reg. Section 1.382-9(j).
21 IRC Section 382(l)(5)(G).
22 IRC Section 382(l)(6); Treas. Reg. Section 1.382-9(j).
23 IRC Section 368(a)(3)(C).

24 Announcement on Decision 2015-01.
25 Treasury Reg. Section 1.1502-911.

[bankruptcy] court" based on the meaning of the term "title 11 case" in the Internal Revenue Code. As a result, the court ruled the partners could, in fact, exclude from taxable income their share of the partnership's CODI.

The determination of which taxpayer (or taxpayers) is included within a title 11 bankruptcy case for purposes of IRC Section 108 is the crux of the contention leading to the Service's nonacquiesence. However, the Service's announcement and contrary position to the court did not come as a surprise to many tax professionals. In practice, the common understanding of tax professionals is that the exclusions for cancellation of indebtedness under IRC Section 108, for instance the insolvency exception and title 11 bankruptcy cases, apply at the partner level – not the partnership. The conflicting views here may indicate future regulatory action will be needed to further address the issue. Until such time, the announcement states that it "is not to be relied upon or otherwise cited as precedent by taxpayers." Taxpayers with similar fact patterns may continue to rely on the Tax Court cases as good authority with an understanding that their position would be contested and likely litigated by the Service.

Entire Consolidated Group Can Protect Tax Attributes Post-bankruptcy

By Amy Kasden and Peter Enyart

Loss corporations frequently incur an ownership change as a result of bankruptcy reorganizations under Chapter 11 (or similar case) of the Bankruptcy Code. Pursuant to Internal Revenue Code Section 382, such ownership changes result in limitations on the post-restructuring company's use of net operating losses (NOLs) and other tax attributes. Fortunately, IRC Sections 382(l)(5) and (l)(6) ("L5" and "L6", respectively) provide special rules to protect the NOLs and attributes of the post-restructuring loss corporation. The preservation of NOLs is an attractive option for taxpayers that anticipate taxable income upon emerging from bankruptcy. As taxable income is generated, the NOLs from the pre-bankruptcy years can reduce or eliminate the corporate tax liability. To this end, L5 provides favorable rules that allow a loss corporation to preserve its NOLs and other tax attributes without limitation, presuming certain conditions are met. Furthermore, an L6 election will subject the NOLs and attributes to limitation under Section 382, but under an alternative computation that accounts for the taxpayer's increased value attributable to the cancelled debt following the change in ownership.

When a loss corporation is a member of a consolidated group, the IRC Section 382 rules within the consolidated regulations generally apply to the group on a single entity basis.[26] However, uncertainty exists as to how L5 and L6 apply when a member of a consolidated group is not a party to the bankruptcy. In a Private Letter Ruling[27] 201435003, the IRS ruled that a consolidated group that incurred an ownership change as part of a bankruptcy reorganization would be treated as a single entity, including the non-debtor subsidiaries. Thus, the NOLs and attributes of the entire group were eligible for L5 and L6 treatment, including the NOLs and attributes of the affiliates that were not included in the bankruptcy proceedings.

In the ruling, the IRS provides welcome clarity on how the section 382 rules apply to non-bankrupt members of a consolidated group. Taxpayers should consult their tax advisors for more information on how the section 382 rules may apply to a loss corporation undergoing or contemplating bankruptcy proceedings.

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Peter Enyart is a tax manager in McGladrey's Mergers and Acquisitions Tax Practice. His professional experience includes serving both publicly-traded (SEC) and closely-held clients on federal, international, and state and local tax matters.

In his current role at McGladrey, Peter focuses on advising clients on the federal tax consequences of mergers, acquisitions and dispositions, including tax structuring and tax modeling, tax due diligence, change in control attribute analysis, transaction cost analysis, bankruptcy tax analysis and structuring, debt restructuring, and stock basis and earnings and profits studies. Recently, Peter completed a rotation with the firm's Washington National Tax office in Washington, DC where he delivered advice and consultation regarding complex corporate and partnership tax matters.

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Amy Kasden is a manager in McGladrey's Washington National Tax office. Amy's client service focus is in advising clients and firm personnel on corporate merger and acquisition activity; analysis of net operating loss issues, spin-offs, debt restructuring, consolidated group issues, bankruptcy, and analysis of transaction costs. She develops and delivers internal and external training on corporate tax and transaction related issues, and authors McGladrey tax alerts and tax digest articles.

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26 Treasury Reg. Section 1.1502-911.
27 Private Letter Ruling 201435003.

Guiding Orchestra and Opera Companies Through the New Business Landscape

ANDREW MASINI, CIRA
CohnReznick LLP

In the face of financial and economic challenges, a number of orchestra and opera companies either liquidated under bankruptcy or simply closed their doors. High-profile examples in the past four years include the Louisville (KY) Orchestra, the Syracuse Symphony Orchestra, the New Mexico Symphony, the Honolulu Symphony, the San Antonio Opera, the Baltimore Opera and the New York City Opera. Others either reorganized with or without bankruptcy protection or curtailed their missions.

Whether emerging from a reorganization/restructure or striving to avoid such an occurrence in the first place, orchestra and opera companies will continue to cope with steady declines in patrons and ticket sales as well as the number and sizes of donations and grants.

Managing these challenges will require a heightened reliance on an effective conservancy business model. The model, which structures donors and artistic organizations as partners in sustaining the profitability and growth of the organization, has historically served orchestra and opera companies well. However, effectively addressing the challenges arising from the changing economic landscape will necessitate a retooling of the standard conservancy business model. The new model must focus on areas such as the separation of the core businesses, marketing endeavors, underwriting specific costs, and financial measurement and planning.

Countermeasures with Obvious Limitations

Companies that have responded to the declines in the predictable ways have run up against the expected limitations:

- *Cutting ticket and subscription prices with the hope of boosting or at least preserving volume.* Not surprisingly, most companies did not find large segments of audiences that were waiting for lower prices. Now that attendance has picked up since the onset of the recession, some companies are confronting the paradox of record turnout but less overall revenue.
- *Cutting the season*. Reducing the number of performances certainly cut the large direct costs, but curtailing the product tended to diminish the perceived value; a company with a shortened season looks like a company that has lost a certain amount of relevance and capability.
- *Cutting costs.* For orchestra and opera companies, the largest cost is that of the performers and production personnel. Cutting compensation for performers may come at a price to the company: it could serve as a disincentive to current performers and thus turn them away and render a pay scale that will not attract the necessary replacements.
- *"Churning" the donor base for additional gifts*. It generally holds true that arts organizations have success with making additional, often emergency, appeals to the existing donor base. Compared with developing new donors, it is relatively quick and easy to get current donors to make additional gifts and persuade past donors to resume giving. Of course, the amount that can be generated is limited and the extra appeals may create or reinforce an image of a declining organization less worthy of donations.

The Conservancy Business Model

Donors view their contributions to the arts differently than those given to charitable organizations: Donors and the artistic organizations they support view themselves as *partners* in conservancy. This partnership concept extends to the ticket buyers and, especially, the subscription audience. The partnership concept contributes to the dependability of donations and the ability to predict levels of giving and sales.

Over years of cycles of appeals and marketing, donors and buyers have also participated in improving the timing of collections. Collections of donations and grants are now routinely made in time to plan the outlays. With regard to ticket receipts, the rise of subscription sales (advance sales of an entire season) greatly enhanced the business model by shifting much of the purchases from just days and weeks before performances to weeks before the season opens – well in advance of much of the cash outlays. Now companies routinely budget with confidence for contract and pension obligations, long- and short-term debt, royalties, and guest appearances. Even in the cases where a business failure indicates a mismatch between receipts and outlays, the story is often that the board and management predicted a shortfall, but then placed too much confidence in turnaround measures.

Tweaking the Conservancy Model and Other Strategies

The increasing challenge of raising donations and revenue will force new efficiencies on the business model for performing arts. As is the norm with good trends, the early adopters benefit most.

Separate the Core Businesses: The Company, the Venue and the Endowment

The business of the performance company is different from the business of the performance space and both are different from the business of the endowment. There may be a need to manage two or all three together within the same organization, but even in that case, it is useful for the governing board and management to maintain the mental rigor necessary to distinguish between the respective missions and how to manage them.

A venue that presents the works of several performance companies will emphasize variety: different ensembles and artists, perhaps even separate concert series such as jazz, classical, pop and dance. By contrast, each performance company will strive to emphasize variety *within* its repertoire. For example, a chamber orchestra that is perhaps dedicated to the Baroque era may emphasize the variety of guest soloists and perhaps the occasional foray into another era. An opera company may distinguish between light and dramatic works or highlight a season of primarily concert or semi-staged presentations punctuated by a fully-staged production.

The venue matches rental revenue and perhaps some donations to the costs of utilities, custodial staff, technical staff, and administration. The performance company matches donations and ticket sales to the main cost of performers followed by production, marketing, royalties, and administration.

When those separate missions are combined in, for example, a symphony orchestra that maintains its own performance space, the governing board and management are coping with a complexity that tends to mask problems. A simple exercise of allocating a portion of revenue equivalent to the going rate of rent for a similar performance space will allow the company to measure the performance of the venue business.

There is good reason to create a separate legal entity for the endowment. Placing the endowment in the hands of its own governing board helps eliminate any appearance of endowment mismanagement and, for that matter, discourages potential raiding of the endowment. Separate ownership of the endowment insulates it from the fortunes of the performance company or the venue. Donors will be more encouraged to fund the endowment if they know that the mission will be supported even if the company or the venue should fall upon hard times and be forced to close down. The endowment can fulfill the expectations of the donors by shifting its support to an appropriate entity.

If it is not practical to place the endowment in a separate legal entity, then the company management has to govern the endowment in a transparent manner, assuring its independence and integrity.

New Focus on Combining Marketing Resources

Where a venue is a standalone business presenting various performance companies, the core businesses of the venue and the companies overlap in the promotion of the venue's season-long program.

To be sure, there has always been cooperation among the venues and the companies in marketing endeavors, but joint marketing efforts often do not get the attention they deserve in a market where the proliferation of e-blasts, websites, and social media needs to be met with smart, efficient message delivery, not just additions to the clutter.

For the venue, a significant competitive advantage can be the ability to quickly and efficiently incorporate: 1) the mailing lists (email and regular mail) of each of the performance companies in its own mailings, etc.; and 2) the social media links – Facebook, Twitter, Google+ – of the companies on its own social media sites.

ABOUT THE AUTHOR

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Andrew Masini has over 25 years of private accounting and advisory experience. For CohnReznick, he provides bankruptcy, restructure, forensic, litigation and financial advisory services to clients in a variety of industries: manufacturing, wholesale/distribution, professional services, financial services, telecommunications, real estate and nonprofits. He has previously published articles on the Foreign Corrupt Practices Act, healthcare and arts management.

The New Angel

Performance companies have been encouraging donors to underwrite specific costs, for instance, the printing of programs or the rental of the venue. Lining up donors for these specific expenses is a way of making sure the donation precedes the expenditure. The donor, in turn, gets credit for something tangible — something that the patron can see, hear or feel and associate with the donor.

Years of cultivating these substantial underwritings have created an unwanted problem. Donors of smaller amounts – $25, $50, $100 – are made to feel as if their donations are lost in anonymous allocations among direct and indirect costs. This tends to make donors of smaller amounts less inclined to compete with the underwriters for attention.

This situation has created a role for a new angel – the underwriter of *administrative* costs. The underwriting of administrative costs returns power to those $25, $50, and $100 donations. Thanks to the new angel, each and every cent of these donations is now contributing directly and completely to the tangible aspects of the mission. Meanwhile, the underwriter receives recognition for two achievements: a sizable, imperative underwriting and enhancing the role of all other donations, large or small.

Rolling 12-Month Financial Views

Anticipation of problems is the overriding concern of financial analyses.

Traditional budget and performance views look at the current year and the upcoming year as separate items. However, the relative fortunes and challenges of one year intimately affect those of the next. It makes sense to reflect that link in planning. Replacing the current year view with a rolling 12-month view links current resources with the next 12 months of operation. If the company is three quarters of the way through its year, then it is appropriate for management to be looking at the first three quarters of next year as part of the current operation.

Simple, Smart Analyses

A few relevant comparisons can go a long way in financial measurement and planning.

The board or management of a performance company or venue may feel that they are not economists, nor can they afford to hire one. Consequently, they assume that meaningful economic analysis is out of reach. Hence, a typical budgeting exercise may consist of looking at last year's donations and making the forecasted amount five percent higher or lower depending upon the board's collective "gut feeling" as to whether the economy is strengthening or weakening.

However, there is no need to budget purely by guessing.

There are several economic indicators readily available on the internet that can be used to replace the previously mentioned "gut feeling" with more substantiated reasoning. For example, historical unemployment rates by state or county can be compared against donation levels, potentially revealing strong correlations that can be used in planning.

Another opportunity for easy, yet insightful, analysis can be found in the comparison of the percentage mix of income – donations from individuals, corporate support, sales, investment income and government grants – to the organization's history and to that of similar organizations. Differing trends in either comparison may indicate available but overlooked funding sources. For example, underrepresentation in corporate support may indicate that a renewed courting of businesses will be fruitful.

Addressing Excess Seating Capacity

Whether attendance is in decline or not, filling a house is often a problem.

Full houses give audiences the impression that they are getting a lot of bang for their buck. Conversely, empty seats create the impression that the performing company is of lesser value. It is a frustrating problem because it tends to unfairly hold true *regardless of the size of a venue*. For example, 185 people sitting in a 200-seat theater encourages a favorable view of the performance, but having the same 185 people spread out in a 500-seat venue suggests the performance company is not an adequate draw.

Unfortunately, performance companies usually do not have the opportunity to match seating capacity to the audience size. In an attempt to fill the house, some companies use ticket giveaways. The problem is that ticket giveaways erode the perceived value of the paid ticket. A company can find itself creating an expectation among its patrons that no one should have to pay the sticker price. These companies are weighing the devaluation via empty seats with the devaluation via ticket giveaways.

There is a caveat to this and that is ticket giveaways that are genuine outreach to people who could not normally afford or get to these concerts such as music students, retirees, or nursing home residents. Patrons paying full price are less likely to see themselves as disadvantaged by this type of giveaway.

Companies should be on the lookout for an opportunity: as venues are newly built or renovated, they are likely to offer a combination of both large and small spaces or "flex space" where audience seating can be tailored to the attendance to create the image of full houses.

Another Venue Consideration

Most orchestra and opera companies build fundraising events around special performances. If a company is in a position to change or renovate a venue, consider that a superlative venue will have integrated the facilities that support fundraising: reception and dining areas with risers or a stage for small ensembles, kitchens suited to catering, and doors and ramps suited to loading and unloading.

An Overlooked Asset

Many companies record their performances. A library of past performances has value that may not be apparent because it cannot easily be converted into revenue through, for example, sales of DVDs or downloads. However, the recordings, and even the existence of the library, can be used to attract donors or merger partners, and create free downloads and distributions to raise awareness of the company.

Another overlooked aspect of the library is that segments of each performance can be edited and packaged into different collections to create new items focused by theme, genre or "best of" collections. A new collection can be tailored for any given donor, foundation, or audience segment.

Educating the Donor

Potential contributors would be turned off by a litany of costs or an analysis of cost drivers. However, these contributors have been sheltered from two insights that can help a company greatly when it is seeking funding.

First, the majority of potential contributors do not realize that royalties are a significant cost of presenting music composed after 1922. Hence, a Leonard Cohen or an Aaron Copeland work presents a significant hurdle that the works of Bach, Beethoven, and Mozart do not.

Second, a majority of potential contributors do not realize that symphonic works composed after Beethoven's time generally called for much larger orchestras. Consequently, much of the Classical and Romantic era music is significantly more costly to perform than is the music of the Baroque era.

The "education" does not have to be the stuff of dry lectures and articles. Both of the above items lend themselves to marketing *opportunity*. They play to the emphasis of variety: the "chamber orchestra concert" that opens a season versus the "grand symphony performance" that closes the season and, in between, the "annual spotlight on the modern era." The complementary appeals for funding can succinctly point out the differences in costs. This would demonstrate clearly the link between increases in support with the variety of the repertoire that the company can achieve.

The Good News

The conservancy business model will still have to cope with and address the steady decline in attendance at classical music concerts and a corresponding shrinking of support. The good news is that the observations above do not point to the need for an overhaul – rather, they point to modification, adaptation, and fine-tuning.

Financial Due Diligence for Companies in Bankruptcy: Value to Be Had

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Can performing financial due diligence of a bankrupt company yield any benefits? Answering this question in the affirmative may seem counter-intuitive, given that due diligence focuses on the historical financial information of an entity to predict future performance. In many instances, the entity in question has been distressed for a period of time, thus the historical financial performance is not indicative of the future. In addition, since the §363 sale process provides for (i) the purchase of assets free and clear of liens and most claims and (ii) a structured sales process under the supervision of the Court, it can be argued that due diligence is unnecessary. However, due diligence is beneficial in instances where a company's assets are bought and are expected to continue operating into the future. Despite the Company's status as a Chapter 11 debtor, assets such as intellectual property, patents, trade secrets, and customer lists may prove valuable. Once purchased through a bankruptcy court supervised proceeding, a strategic purchaser would seek to "remobilize" these assets on its own viable platform. While the bankrupt entity may have "noise" in its financial results, understanding such factors as the historical financial performance, normalized cost structure, and internal control processes will facilitate a better understanding of the business, identify high-risk areas, and allow for a more efficient financial modeling process.

When performing due diligence of a bankrupt entity, there are several considerations that should be made in order to extract actionable insights from the process. These include:

When should the due diligence process begin?

Ideally, the process should commence once the stalking horse bidder is selected. The stalking horse will (i) be entitled to a break-up fee and expense reimbursement protection; and (ii) control many terms of the transaction, creating advantages and building hurdles which competing over-bidders may have to meet. A key benefit of this approach includes a head-start in the diligence process that can potentially result in early insights that can help determine the most favorable economics of the transaction.

However, if not selected as the stalking horse, does one proceed with diligence for the same reasons? Yes — while there are several benefits to being appointed the stalking horse, sole exclusivity to the performance of due diligence upon the bankrupt entity is not one of them and, as such, bidders that have not been selected can still obtain valuable insights comparable to those of the stalking horse.

What is the current state of the entity's overall accounting and financial reporting processes and internal control environment?

The bankruptcy process is a stressful one for the debtor. Often there is a breakdown in the overall internal control environment and reporting processes as a result of employee attrition and a lack of focus as the business is being managed in "crisis" mode. Identifying significant risk areas early on in the diligence process such as weak or absent accounting and financial resources will ensure that these areas are addressed in an expedited and efficient manner post-bankruptcy.

Have the entity's pre- and post-petition liabilities and their impact on normalized working capital been addressed?

Determining normalized working capital is often challenging in a bankruptcy situation. In addition to stretching payables, there

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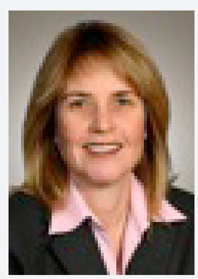

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may be instances where the debtor is no longer offered credit terms from certain vendors, and therefore has to pay those vendors in advance of shipment of goods/services. Further, customers may use the bankruptcy process to slow payments, especially if they themselves are having cash flow issues.

The diligence process should focus on understanding the normalized payment terms, both for accounts receivable and trade payables. In addition, ensuring a normalized level of accrued expenses is important as these expenses are often not accrued, but are recorded when paid.

To what extent has the ability to grow revenue been affected by the bankruptcy?

Often during bankruptcy, debtors find that their customers are wary to do business with them, especially where the goods or services have a long lead time and take a long period for service delivery.

Understanding such factors as customer mix, significant customer losses, and declines in customer revenue will help focus efforts post-bankruptcy. It will also help facilitate revenue assumptions in the forecast.

Lower revenues will impact gross margin percentages, especially if there is a high fixed cost component in the overhead structure. An analysis of projected revenues as compared to historical revenue levels can help determine true earnings potential.

Have operating expenses been distorted due to the bankruptcy?

Typically, costs associated specifically with the bankruptcy, such as fees paid to advisers and legal counsel, are classified in their own category and presented separately from ongoing operating expenses. Notwithstanding the above, operating expenses can be distorted as a result of the bankruptcy process. A few examples include:

- **Cash basis of recording expenses** – Expenses are often recorded on a cash basis due to cash constraints combined with a breakdown in the overall accounting and financial reporting environment. This results in lumpiness in the operating results, as well as the potential for missing costs.
- **Unsustainable practices** – The entity may have implemented cost-cutting measures such as salary cuts or negotiations with vendors for short-term relief that are not sustainable post-bankruptcy.
- **Carve-out stand-alone issues** – Where the business being acquired is a division/business unit, understanding the true underlying cost structure is essential. For example, on a stand-alone basis, what additional resources are required? The diligence process facilitates upfront identification of these areas so there is sufficient time available to properly plan for the future.

Summary

Performing financial diligence on companies in bankruptcy can yield positive benefits and provide clarity on those key drivers that will impact the overall financial performance, as well as provide useful insights in building the projection model and the underlying assumptions.

NY Court Clarifies "Foreign Representative" for Chapter 15 Recognition

On July 13, 2015, the United States Bankruptcy Court for the Southern District of New York refined the qualifications of "foreign representative" for purposes of granting recognition in a Chapter 15 proceeding. [1]

Caught up in the Petrobras corruption scandal infecting the oil and gas industries of Brazil and the country's political leadership and causing further challenges for an already struggling Brazilian economy, OAS and a number of its domestic and foreign affiliates and subsidiaries, which together form one of Brazil's largest construction companies, sought protection under Brazil's judicial reorganization laws. The OAS Group's commencement of judicial reorganization proceedings followed unsuccessful efforts to restructure out of court, which included several transactions in which changes were made to the corporate structure of the OAS Group and assets were transferred among members.

Prior to and following the commencement of the reorganization proceeding, the OAS Group restructuring transactions were fiercely opposed by two principal holders of the approximately $875 million of senior notes issued and guaranteed by certain members of the OAS Group. The holders assert the restructuring transactions improperly caused assets to be transferred from guarantors to non-guarantors of the note indebtedness and effected a merger of two guarantors that resulted in the surviving entity having a materially diminished ability to satisfy its guaranty obligations and, therefore, violated the holders' rights under the governing agreements to secure repayment of the notes. The holders initiated litigation against the OAS Group in New York state courts.

In response to the holders' successful efforts in the state court litigation to attach the OAS Group's liquid assets located in the United States, the OAS Group sought recognition of its Brazilian reorganization proceedings under Chapter 15 of the Bankruptcy Code in the Southern District of New York. By resolution, the OAS Group's boards of directors empowered Renato Tavares, legal officer for several members of the OAS Group, to administer the reorganization of the OAS Group's assets and affairs in the Brazilian proceedings and appointed him as the OAS Group's agent and attorney-in-fact for purposes of filing petitions for recognition in foreign jurisdictions.

The holders opposed recognition of the Brazilian proceedings on several grounds, including Tavares's qualification as a "foreign representative."[2] In support, the holders emphasized the fact that the term foreign representative is defined in the Bankruptcy Code to mean "a person or body, including a person or body appointed on an interim basis, authorized in a foreign proceeding to administer the reorganization or the liquidation of the debtor's assets or affairs or to act as a representative of such foreign proceeding." 11 U.S.C. § 101(24) [emphasis added]. In addition, the holders noted that a petition for recognition must be accompanied by:

1 *In re OAS S.A., et. al.*, 2015 Bankr. LEXIS 2302 (Bankr. S.D.N.Y. July 13, 2015).

2 The holders also argued that the primary obligor on the notes, a special purpose Austrian entity with no real operations, did not have a center of main interests in Brazil. The Bankruptcy Court determined, however, that because the only hope of repayment of the debt was by the Brazilian guarantors, who undoubtedly had their center of main interests in Brazil, and all of the limited board actions of the Brazilian directors took place in Brazil, the special purpose entity also had its center of main interests in Brazil.

(1) a certified copy of the decision commencing such proceeding and appointing the foreign representative;

(2) a certificate from the foreign court affirming the existence of such foreign proceeding and of the appointment of the foreign representative; or

(3) in the absence of evidence referred to in paragraphs (1) and (2), any other evidence acceptable to the court of the existence of such foreign proceeding and of the appointment of the foreign representative.

11 U.S.C. § 1515(b) [emphasis added]. From the holders' perspective, the plain meaning of these provisions compelled the conclusion that Tavares did not have the requisite authority to seek recognition because he was not appointed as a foreign representative by the Brazilian court.

In rejecting the tacit "appointment" requirement, which the Bankruptcy Court found to be ambiguous, the Bankruptcy Court instead focused on the phrase "authorized in a foreign proceeding" under Section 101(24). The Bankruptcy Court followed an earlier interpretation of the phrase adopted by the Northern District of Texas and approved by the Fifth Circuit, holding that "authorized in a foreign proceeding" essentially meant "authorized in the context of or in the course of a foreign proceeding" with the result that where the foreign law allows a debtor to act as a debtor-in-possession and manage its own affairs, the debtor itself can provide the applicable authorization. [3]

This interpretation, the Bankruptcy Court held, was consistent with the legislative intent. Unique to Chapter 15 of the Bankruptcy Code is its source. While adopted by Congress to facilitate the protection of debtor and creditor rights in cross-border insolvencies, the language used, including the definition of foreign representative was lifted, almost entirely, from the Model Law on Cross-Border Insolvency promulgated by the United Nations Commission on International Trade Law.[4] As reflected in the reports of the Working Group on Insolvency Law responsible for drafting the Model Law, which the courts have considered and relied upon in interpreting Chapter 15, the drafters rejected the requirement that the foreign representative be specifically authorized by statute or court order to seek recognition.

The Bankruptcy Court then interpreted Brazil's bankruptcy law to determine whether the OAS Group's boards of directors could authorize Tavares to obtain recognition of the Brazilian proceeding. That determination turned on whether the provisions of Brazil's bankruptcy law under which the OAS Group was operating functionally made the OAS Group a debtor-in-possession. In this analysis, the Bankruptcy Court focused on Article 64 of Brazil's bankruptcy law, which provides: "[d]uring the in-court restructuring procedure, the debtor and his officers shall be kept in the management of the business activity, overseen by the Committee, if any, and by the judicial administrator."[5] Relying on the affidavit of the OAS Group's Brazilian counsel, the Bankruptcy Court concluded that Brazil's bankruptcy law allowed the OAS Group's management to retain full control over its business and assets subject to the oversight of a judicial administrator, which may step in to liquidate a debtor's assets under certain conditions. While not the mirror image of a debtor-in-possession under U.S. bankruptcy law, Brazil's bankruptcy law met the qualifications under the Model Law for a debtor-in-possession, which was all that was required to give the OAS Group management authority to empower Tavares with authority to seek recognition in the U.S. courts.

Although, arguably, the OAS decision breaks no new ground, it does signal a unified theme emerging in disputes over a foreign representative's authority to seek recognition[6] and provides helpful insight as it relates to the interpretation of Brazil's bankruptcy law.[7] Under the OAS holding, foreign jurisdictions with insolvency laws that leave control of the operation of the debtor's business in the hands of management, even where the law, like Brazil's bankruptcy law, does not implement the Model Law, provide the debtor with sufficient authority to appoint its own foreign representative. Given the dispute that erupted in OAS, however, U.S. counsel for foreign debtors should be mindful of opportunities to preempt challenges to recognition like the one employed by the holders. U.S. counsel may want to inquire of foreign counsel whether, for example, it would be permissible and advisable to seek a court order at the outset of the foreign case that would preemptively resolve any ambiguity about the board-selected representative's ability to file recognition petitions.

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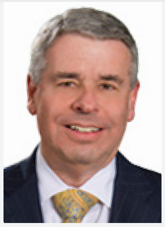

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[3] *Ad Hoc Grp. of Vitro Noteholders v. Vitro S.A.B. de C.V.* (*In re Vitro S.A.B. de C.V.*), 701 F.3d 1031 (5th Cir. 2012).

[4] In addition to the United States, over 20 other jurisdictions have adopted the Model Law since its adoption by UNCITRAL in 1997. While these jurisdictions include Central and South American countries such as Mexico (in 2000) and Chile (in 2014), they do not (as of yet) include Brazil.

[5] This language comes from the OAS decision, which cited to an English translation of Article 64 of Brazil's bankruptcy law, filed as an exhibit in the OAS proceedings.

[6] See *In re Compania Mexicana De Aviacion, S.A. de C.V.*, 2010 Bankr. LEXIS 6538 (Bankr. S.D.N.Y. Nov. 8, 2010) (bench ruling that foreign representative authorized by Mexican equivalent of a debtor-in-possession met qualifications of "authorized in foreign proceeding" for purpose of Chapter 15 recognition petition).

[7] See *In re Rede Energia S.A.*, 515 B.R. 69, 98 (Bankr. S.D.N.Y. 2014) (Brazilian bankruptcy law generally comports with fundamental standards of fairness and civilized jurisprudence as required by 11 U.S.C. § 1506).

FEATURE ARTICLE

Third-Party Releases?—Not So Fast! Changing Trends and Heightened Scrutiny

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In an effort to provide corporate debtors with a fresh start, free from the grips of suffocating debt and the threat of litigation in connection with their financial troubles, the Bankruptcy Code[1] offers numerous benefits and protections to those who submit to the bankruptcy process. However, as corporate structures have become more complex and corporate scandals more prevalent, legislation aimed at curbing corporate abuses has correspondingly expanded and developed. Additionally, the trend of judicial decisions defining the scope of corporate bankruptcy protections has evolved.

This reevaluation of the scope of available bankruptcy protections is particularly evident in cases where the Bankruptcy Code and federal securities laws[2] intersect. Somewhat challenging is the interplay between these two statutory schemes, one that sets out to provide the "honest but unfortunate debtor"[3] with a fresh financial start, "unhampered by the pressure and discouragement of pre-existing debt,"[4] and the other, which seeks to establish accountability for securities fraud and other corporate malfeasance.[5] In recent times, these two statutory schemes increasingly target the same suspect.[6] At first blush, it seems unlikely that the honest, unfortunate debtor and the securities fraud defendant could be closely intertwined, but corporate scandals including *Enron, WorldCom, Global Crossing*, and *Adelphia Communications* are cases in point.

When a debtor is concomitantly the subject of both statutory frameworks—in one, seeking relief, and in the other, the accused, a tension is created with respect to liability. The competing policies of relieving a debtor from the pressure of its preexisting liabilities under the Bankruptcy Code on one hand and providing maximum investor recovery for securities fraud violations under the securities laws on the other force a spotlight to shine on the propriety of court-approved releases from liability in chapter 11 plans. These tensions come to a head when Bankruptcy Code provisions are invoked to protect not only corporate debtors and their affiliates, but also their current and former officers and directors who face some form of independent liability relative to the company's downfall.

The trend of corporate bankruptcies increasingly involving securities fraud litigation against the bankrupt[7] has sharpened judicial acuity in evaluating the scope of Bankruptcy Code protections afforded to the ostensibly honest debtor, its debtor affiliates, and most controversially, its non-debtor affiliates. In the wake of the large corporate securities scandals of the early 2000s, bankruptcy courts have begun to reel in the once liberally cast line of authorizing third-party releases in favor of both former and current directors and officers.

Third-Party Releases Defined

The chapter 11 bankruptcy process culminates with the confirmation of a plan — the document that works, in effect, as a contract between the debtor and its stakeholders, setting out the treatment of the debtor's obligations with respect to each class of creditors and interest holders. One of the primary rehabilitative features the Bankruptcy Code provides is the chapter 11 discharge received upon confirmation of the plan — a benefit reserved solely for the debtor that files for chapter 11 protection and reorganizes.

However, situations arise where a debtor attempts to extend releases to certain affiliated non-debtor parties whose participation in or impact on the chapter 11 process will allegedly affect the debtor's ability to reorganize — the "non-debtor" or "third-party" release. A debtor might seek to extend third party releases to co-debtors, officers, directors, lenders, parents, guarantors, sureties, or insurance carriers where those parties could assert post-confirmation indemnification claims against the debtor, or where the non-debtor party is a potential source of funding for the plan of reorganization. Unlike their less controversial counterpart, these non-debtor releases, in essence, seek to allow non-debtors to reap the benefits of the Bankruptcy Code without undertaking the obligations. Cue the third-party release debate.

The judicial discord regarding third-party releases likely stems from statutory conflict with respect to the permissibility of third-party releases and each court's perception of how those conflicting statutes interact. The Bankruptcy Code provides that upon the court's confirmation of the plan, the debtor receives a discharge of all pre-confirmation debt.[8] Further, Bankruptcy Code section 524(e) provides that the "discharge of a debt of a debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt."[9] Additionally, under section 105(a),

[1] 11 U.S.C. §§ 101 – 1330, *et. seq.*

[2] The Sarbanes-Oxley Act, Securities Act of 1933, Securities Exchange Act of 1934, Public Utility Holding Company Act of 1935, Trust Indenture Act of 1939, Investment Company Act of 1940 and Investment Advisers Act of 1940. *See Sec. & Exch. Comm'n v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963).

[3] *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934).

[4] *Id.*

[5] *Sec. & Exch. Comm'n v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963) ("A fundamental purpose, common to [the series of Acts designed to eliminate certain abuses in the securities industry], was to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry.").

[6] Mark S. Beasley et al., *Fraudulent Financial Reporting 1998-2007, Committee of Sponsoring Organization of the Treadway Commission* at 1 (2010), *available at*, http://www.coso.org/documents/ COSOFRAUDSTUDY2010 _001.pdf. ("Companies engaged in fraud often experienced bankruptcy, delisting from a stock exchange, or material asset sales following discovery of fraud – at rates much higher than those experienced by no-fraud firms.").

[7] *See supra note 6.*

[8] 11 U.S.C. § 1141(d)(1).

[9] 11 U.S.C. § 524(e).

a bankruptcy court "may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title,"[10] but does not allow the bankruptcy court "to create substantive rights that are otherwise unavailable under applicable law."[11]

Facially, section 524(e) appears to create a specific prohibition on discharging non-debtor liabilities. However, the broad equitable powers of the bankruptcy court under section 105(a) present an alternative route that some debtors have taken to evade the apparent prohibition of non-debtor releases under section 524(e). Thus, in cases where a court deems non-debtor releases necessary or appropriate in carrying out a debtor's plan of reorganization, those releases may be permitted under section 105(a). The crux of the debate often turns on how courts perceive the breadth of their section 105(a) equitable powers, and on whether courts interpret the restriction on scope in 524(e) as limiting section 105(a).

Third-party releases come under a court's consideration in various factual contexts that may impact a court's decision to approve the releases at issue. In order to define the focus of this article, and to most efficiently navigate the nuances of judicial opinions on third-party releases, these factual variables must be identified.

The first factual issue relevant to a court's decision on whether to approve the releases is whether the creditor consents to the non-debtor release. If a creditor affirmatively votes in favor of a plan containing third-party releases, or otherwise does not object to the non-debtor's release, such a release is said to be consensual. So long as the release constitutes a binding agreement under basic contract law, most courts take no issue with a consensual third-party release.[12] As such, consensual third-party releases are not within the scope of this analysis. Whether the release is, in fact, consensual is another debate for another article.

The second factual variable of note is whether the claim being released is property of the estate as opposed to a truly direct and independent claim of a creditor. Derivative claims that are property of the debtor's estate include, for example, pre-petition claims for breach of fiduciary duty by officers and/or directors or alter-ego claims[13] asserted by a debtor-in-possession.[14] Since the Bankruptcy Code provides that a plan may provide for the settlement or adjustment of a claim belonging to the debtor or the estate,[15] the issue as to whether derivative claims can be released in a debtor's plan is far less controversial.

Additionally, there is a legal distinction to be made between third-party releases and exculpation provisions. Third-party releases contemplate releases of claims or causes of action held by a non-debtor against another non-debtor, while exculpation provisions encompass releases of claims by both the debtor and non-debtor against professionals and other bankruptcy estate fiduciaries for ostensibly post-petition conduct.[16] Third-party releases offer protection to non-debtors for pre-confirmation liability, whereas exculpation provisions provide estate professionals with qualified immunity covering their reasonable conduct in connection with the bankruptcy case.[17]

Further, even within the particular nonconsensual third-party releases of independent claims that are the focus of this article are releases varying in scope, breadth, and application. For these reasons, generalizations with respect to an analysis of third-party releases is especially perilous and attention to detail is vital in characterizing judicial trends.

Propriety of Third-Party Releases Pre-Enron

The contentious history of third-party releases reaches back nearly thirty years[18] and can generally be attributed to each Circuit's interpretation of the statutory interplay between sections 524(e) and 105(a). In order to evaluate the post-Enron judicial trend towards restrictive interpretation of third-party release law, a survey of each Circuit Court's opinions *pre*-2000 is crucial.

Pre-Enron Courts: Prohibition View of Third-Party Releases

Courts in the Ninth[19] and Tenth[20] Circuits expressed staunch opposition to the allowance of third-party releases since the debate's inception. These courts both held the view that the statutory language of section 524(e) provides a strict prohibition against third party releases — a view that completely removes the court's equitable powers from the equation (the "Prohibition Circuits").

Pre-Enron Courts: Permissive View of Third-Party Releases

The Second,[21] Third,[22] and Fourth[23] Circuits adopted a less restrictive approach — each opining that third-party releases are

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10 11 U.S.C. § 105(a).

11 *In re Metromedia Fiber Network, Inc.*, 416 F.3d 136, 142 (2d Cir. 2005).

12 Joshua M. Silverstein, *Hiding in Plain View: A Neglected Supreme Court Decision Resolved the Debate over Non-Debtor Releases in Chapter 11 Reorganizations*, 23 Emory Bankr. Dev. J. 13, 22-25 (2006).

13 *Steyr-Daimler-Puch of Am. Corp. v. Pappas*, 852 F.2d 132, 136 (4th Cir. 1988) (holding trustee but not creditors could bring an alter ego claim because the claim was property of the estate under Virginia law). Note that the status of an alter ego claim may vary depending upon state law with respect to whether a claim is property of the estate.

14 Joshua M. Silverstein, *Hiding in Plain View: A Neglected Supreme Court Decision Resolved the Debate over Non-Debtor Releases in Chapter 11 Reorganizations*, 23 Emory Bankr. Dev. J. 13, 26-28 (2006).

15 11 U.S.C. § 1123(b).

16 *See In re Exide Technologies*, 303 B.R. 48, 71-75 (Bankr. D. Del. 2003).

17 Ryan M. Murphy, *Shelter from the Storm: Examining Chapter 11 Plan Releases for Directors, Officers, Committee Members, and Estate Professionals*, 20 J. Bankr. L. & Prac. 4 Art. 7 at 2 (September 2001).

18 *Compare Underhill v. Royal*, 769 F.2d 1426, 1432 (9th Cir. 1985) ("[T]he bankruptcy court has no power to discharge the liabilities of a nondebtor pursuant to the consent of creditors as part of a reorganization plan"), with *Kane v. Johns-Manville Corp*. (*In re Johns-Manville Corp.*), 843 F.2d 636, 640, 649 (2d Cir. 1988) (allowing third party- releases).

19 *In re Am. Hardwoods, Inc.*, 885 F.2d 621, 626 (9th Cir. 1989) (holding "[s]ection 524(e), therefore, limits the court's equitable power under section 105 to order the discharge of the liabilities of nondebtors"); *Resorts Int'l, Inc. v. Lowenschuss* (*In re Lowenschuss*), 67 F.3d 1394, 1401 (9th Cir. 1995) ("This court has repeatedly held, without exception, that § 524(e) precludes bankruptcy courts from discharging the liabilities of non-debtors."); *Underhill v. Royal*, 769 F.2d 1426, 1432 (9th Cir. 1985) ("[T]he bankruptcy court has no power to discharge the liabilities of a nondebtor pursuant to the consent of creditors as part of a reorganization plan.").

20 *Landsing Diversified Props.-II v. First Nat'l Bank and Trust Co. of Tulsa* (*In re W. Real Estate Fund, Inc.*), 922 F.2d 592, 600–02 (10th Cir. 1990) (discussing section 523 policy, concluding "[o]bviously, it is the debtor, who has invoked and submitted to the bankruptcy process, that is entitled to its protections; Congress did not intend to extend such benefits to third-party bystanders").

21 *See Securities and Exchange Commission v. Drexel Burnham Lambert Group, Inc.* (*In re Drexel Burnham Lambert Group, Inc.*), 960 F.2d 285, 293 (2d Cir. 1992); *MacArthur Co. v. Johns-Manville Corp.*, 837 F.2d 89, 93 (2d Cir. 1988) ("Additional authority for the injunction is to be found in section 105(a) of the Bankruptcy Code, which permits the Bankruptcy Court to 'issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.'").

22 *In re Cont'l Airlines*, 203 F.3d 203, 214 (3d Cir. 2000).

23 *See Menard-Sanford v. Mabey* (*In re A.H. Robins Co.*), 880 F.2d 694, 701-02 (4th Cir.1989) (approving third-party release under 11 U.S.C. § 105(a)).

permissible, at least under certain circumstances (the "Permissive Circuits").

Second Circuit

In *In re Johns-Manville Corporation*,[24] the debtor asbestos manufacturing company entered into settlements with certain of its insurers that provided for the release of all claims against those insurers in exchange for a cash contribution that would become the "cornerstone" of the debtor's plan of reorganization.[25] The plaintiff — a distributor of the debtor's asbestos products and a coinsured under the debtor's insurance policy — argued the release constituted an improper discharge of the insurers.[26]

The Second Circuit held the release of plaintiff's claims against the debtor's insurers was permissible because (i) it did not provide the "umbrella protection of a discharge in bankruptcy;" (ii) it only precluded claims against the settling insurers that arose from or were related to the debtor's insurance policies; and (iii) the plaintiff's claim was not released, but "simply channeled away from the insurers and redirected at the proceeds of the settlement."[27] The Second Circuit's ruling focuses on the narrow application of the releases (only to settling insurers) and the availability of a mechanism for creditor recovery beyond the plan.

In *In re Drexel Burnham Lambert Group, Incorporated*,[28] the Second Circuit approved a release that enjoined any future actions by a class of securities claimants against the debtors' directors and officers in exchange for (i) the debtors' completion of its $350 million payment in connection with a pre-bankruptcy settlement of a Securities and Exchange Commission ("SEC") civil enforcement action; and (ii) a $1.3 billion "pooled recovery" that would be realized as a result of a district-court-approved global settlement of claims against the debtors' directors and officers.[29]

The Second Circuit's paragraph-long analysis of the propriety of the third party-release included a conclusory determination it was an "essential element" of the debtors' plan because "without the injunction, the directors and officers would be less likely to settle."[30] The court's analysis omitted any reference to the fact that the claims against the debtors outnumbered the assets of the estates by tenfold,[31] and thus, a full recovery for creditors was not feasible even taking into account the "essential" concessions offered to obtain the releases. Most importantly, the release was not opposed by the representative of the class of securities fraud claimants.

Fourth Circuit

In *A.H. Robins Company, Incorporated*,[32] the court upheld a non-debtor release that enjoined certain mass tort plaintiffs' claims against the debtor's directors, the debtor's attorneys, the debtor's insurer (Aetna),[33] and Aetna's attorneys. The Fourth Circuit explained the release was permissible because (i) it was essential to the plan since without the releases, the debtor faced potential exposure for future indemnification claims; and (ii) the mass tort claimants would be fully compensated through a claims resolution trust provided for in the plan; and (iii) 94.38% of claimants voted to accept the plan.[34]

Significantly, and illustrative of the then existing judicial attitude toward third-party releases, the court's reasoning assumes that the *capped* estimate of unliquidated and even future claims was sufficient to cover the claimants' damages. The court offered a single analysis for all the releasees, and failed to distinguish between those contributing to the plan and those offering no contribution. Additionally, the court approved the third-party releases in favor of the debtor's noncontributing directors.[35]

Third Circuit

In *In re Continental Airlines*,[36] the Third Circuit refused to issue a bright-line ruling on the propriety of third-party releases, explaining that such a decision was unnecessary to the court's ultimate opinion.[37] However, the court made favorable reference to the Second and Fourth Circuit rulings in *Manville, Drexel*, and *A.H. Robins,* and implied that had the bankruptcy court below made specific findings that the releases were fair and necessary to the debtors' plan of reorganization, the releases might have been permissible.[38] Thus, while the Third Circuit did not expressly rule that section 105(a) allows for the approval of non-debtor releases, the Third Circuit did not adopt the prohibition view, and fell directly in line with the Permissive Circuits.

Subsequently, the District of New Jersey solidified the Third Circuit's alignment with the views of *Manville, Drexel*, and *A.H. Robins* in *In re American Family Enterprises*.[39] The court upheld a release covering a laundry list[40] of parties based on the contribution of one party, explaining "this court must determine only that sufficient compensation is being paid to the class, and need not speculate as to the appropriate contribution of each defendant. The release of noncontributing defendants through a settlement agreement is no

[24] *MacArthur Co. v. Johns-Manville Corp.*, 837 F.2d 89, 90 (2d Cir. 1988).

[25] *Id.*

[26] It should be noted that although the released claim in *Manville* arguably borders the line between a direct and derivative claim, courts and commentators alike have hesitated to categorize the claim as derivative. *See* Joshua M. Silverstein, *Hiding in Plain View: A Neglected Supreme Court Decision Resolved the Debate over Non-Debtor Releases in Chapter 11 Reorganizations,* 23 Emory Bankr. Dev. J. 13, 55 n. 238 (2006).

[27] *Johns-Manville Corp.*, 837 F.2d at 91.

[28] *In re Drexel Burnham Lambert Group, Inc.* 960 F.2d 285, 293 (2d Cir. 1992).

[29] *Id.* at 289 n. 2.

[30] *Id. at 293.*

[31] *In re Drexel Burnham Lambert Grp., Inc.*, 130 B.R. 910, 914 (S.D.N.Y. 1991) *aff'd*, 960 F.2d 285 (2d Cir. 1992).

[32] *In re A.H. Robins Co.*, 880 F.2d 694 (4th Cir.1989).

[33] The releases in favor of Aetna do not concern derivative claims because the claimants sought recovery in tort. *Id.* at 700-01.

[34] *Id.* at 700-02.

[35] *See In re A.H. Robins Co., Inc.*, 88 B.R. 742, 751 (E.D. Va. 1988) *aff'd*, 880 F.2d 694 (4th Cir. 1989) (noting that contributions from the Robins family and Aetna provided adequate consideration for the releases).

[36] 203 F.3d 203, 214 (3d Cir. 2000).

[37] *In re Cont'l Airlines*, 203 F.3d 203, 214 (3d Cir. 2000) ("Given the manner in which the issue has been presented to us, we need not establish our own rule regarding the conditions under which non-debtor releases and permanent injunctions are appropriate or permissible. Establishing a rule would provide guidance prospectively, but would be ill-advised when we can rule on Plaintiffs' appeal without doing so.").

[38] *In re Cont'l Airlines*, 203 F.3d 203, 215 (3d Cir. 2000) ("Unlike in cases such as *Manville, Drexel*, and *Robins*, we have found no evidence that the non-debtor D&Os provided a critical financial contribution to the [debtors'] plan that was necessary to make the plan feasible in exchange for receiving a release of liability for Plaintiffs' claims."); *Id.* at 214 (explaining that because the bankruptcy court never addressed the release, the order confirming the plan "was not accompanied by any findings that the release was fair to the Plaintiffs and necessary to the [debtors'] reorganization").

[39] While this release was technically decided in the settlement context, the funding agreement releasing the parties was "the essential vehicle by which the Debtors c[ould] obtain the funds needed to perform their monetary obligations under the Plan" and is thus substantially similar to the plan context. *In re Am. Family Enters.*, 256 B.R. 377, 390 (D.N.J. 2000).

[40] "Released Persons" was defined as "[all the defendants, their affiliates,] the past, present and future officers, directors, partners, shareholders, members, employees, agents, trustees, legal representatives, insurers and attorneys of all of the foregoing; and the heirs, executors, administrators, successors and assigns of all of the foregoing." *Am. Family Enters.*, 256 B.R. at 431.

reason for disapproving the compromise."[41] The court added that "such injunctions and releases are customary and ordinary in large Chapter 11 cases."[42]

Circuits Offering Additional Guidance

Prior to the early 2000s, the First,[43] Fifth,[44] Seventh,[45] Eleventh,[46] and D.C.[47] Circuits did not address the distinct issue of whether to approve a nonconsensual third-party release of an independent claim in a plan of confirmation. The Sixth and Eighth Circuits did not issue any opinions sufficiently on topic.

Of the additional decisions, only the Court of Appeals for the District of Columbia offered an opinion that expressed a somewhat-restrictive analysis of the propriety of third-party releases. The court held a plan provision which required one creditor to release a direct claim (where all other creditors released derivative claims) against third parties funding the debtor's plan in order to participate in the fund did not constitute the equal treatment of creditors required for purposes of plan confirmation.[48] The opinion suggests a need for proportional contribution by proposed releasees.

The other Circuit courts offered decisions substantially in line with the permissive rulings of the Second, Third, and Fourth Circuits. Specifically, the First Circuit decision offers clear guidance with respect to the views of the Circuit. In *Monarch Life Insurance Company*,[49] the First Circuit upheld a permanent injunction in a plan of reorganization based on promissory estoppel principles because the plaintiff failed to challenge the confirmation order. In determining whether the release issue had been actually litigated for promissory estoppel purposes, the First Circuit explained "the bankruptcy court plainly signaled its endorsement of the Plan proponents' request for a broad injunction extending 'incidental' protection to all noncontributors who might otherwise implead Plan contributors as third-party defendants in subsequent state court actions."[50] While the First Circuit did not address the issue head-on, the court's broad interpretation of the propriety of even incidental third-party releases is evident.

41 *Am. Family Enters.*, 256 B.R. at 428. (citation omitted).
42 *Am. Family Enters.*, 256 B.R. at 406.
43 *Monarch Life Ins. Co. v. Ropes & Gray*, 65 F.3d 973, 985 (1st Cir. 1995).
44 *See Feld v. Zale Corp.* (*In re Zale Corp.*), 62 F.3d 746, 760 (5th Cir. 1995) (in the context of a settlement, reversing approval of settlement between debtor, the debtor's directors and officers, and the creditors' committee that permanently enjoined a variety of existing and potential claims against the settling defendants on the ground that the injunction impermissibly discharged non-debtor liabilities).
45 *Matter of Specialty Equip. Cos., Inc.*, 3 F.3d 1043, 1049 (7th Cir. 1993) (appeal of confirmation order containing third-party releases equitably moot for substantial consummation).
46 *See Matter of Munford, Inc.*, 97 F.3d 449, 455 (11th Cir. 1996) (in the context of a settlement, affirming a district court's ruling that section 105 authorized a bankruptcy court to permanently enjoin nonsettling defendants from asserting contribution and indemnification claims against a defendant consulting firm when the permanent injunction was integral to the debtor's settlement with the consulting firm and the bar order was fair and equitable).
47 *See In re AOV Indus., Inc.*, 792 F.2d 1140, 1154 (D.C. Cir. 1986) (holding a plan provision releasing the liabilities of non-debtors was unfair because the plan did not provide additional compensation to a creditor whose direct claim against non-debtor was being released, where other creditors' claims were derivative).
48 *See AOV Indus.*, 792 F.2d at 1151-54.
49 *Monarch Life Ins.*, 65 F.3d at 985.
50 *Id.* at 982.

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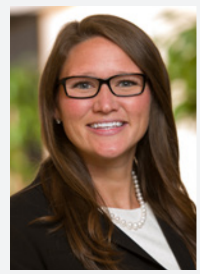

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Enron's Collapse and the Sarbanes-Oxley Act

The collapse of Enron in the fall of 2001 shed light on the corporation's institutionalized, methodical accounting fraud and deceptive business practices. Enron senior management was hit with a plethora of federal charges including conspiracy to commit securities and wire fraud, securities fraud, wire fraud, making false statements to auditors, insider trading, and bank fraud.[51] Former Enron Chief Executive Officer Jeffrey Skilling faced thirty-five criminal securities fraud charges stemming from his misrepresentation of company financials, which included concealing Enron's debt and inflating its profits.[52]

Disclosures throughout Enron's high-profile bankruptcy proceedings led to federal indictments for Enron auditor Arthur Anderson, LLP,[53] which snowballed into "revelations of accounting fraud and insider self-dealing at several large corporations, nearly all of which were thereafter pushed into bankruptcy: Adelphia Communications, Global Crossing, Tyco International, and WorldCom."[54]

51 *Breakdown of the Charges Against Enron's Top Officers*, N.Y. Times, Jan. 18, 2006, at 1-2.
52 *Id.*
53 Ken Brown and Ianthe Jeanne Dugan, *Arthur Andersen's Fall From Grace Is a Sad Tale of Greed and Miscues*, Wall St. J., June 7, 2002, *available at* http://www.wsj.com/articles/SB1023409436545200.
54 Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 Yale L.J. 1521, 1545 (2005).

Along with the demise of these mega-corporations came widespread financial devastation and uncertainty for investors, employees, and the American public at large. Consequentially, the Gallup Public Opinion Poll measuring confidence in big business between 1990 and 2003 shows the percentage of the public that had "either a great deal or quite a lot of confidence in big business in 2002 — 20% — was the lowest percentage in more than a decade and represented a substantial drop from the relatively high level of confidence — an average of 29% — over the prior five years, 1997 to 2001."[55]

The Sarbanes-Oxley ("SOX") Act of 2002 reflects the legislative reaction to the corporate governance issues exposed by the corporate scandals of the early 2000s. Whereas traditional federal securities law focused predominantly on disclosure requirements and misrepresentations or omissions, SOX marked the federal legislature's transition to regulation through substantive corporate mandates.[56] SOX's new legislation added provisions requiring the independence of corporate auditors, forbidding corporate loans to officers, mandating management certification of corporate financial statements, and applying penalties for executives' misrepresentation in financial statements.[57] One particularly telling reform is SOX's contribution to the Bankruptcy Code's section on exceptions to discharge. Under 11 U.S.C. § 523(a)(19), an individual debtor is prohibited from receiving a discharge of any debt for violation of federal or state securities laws and their related regulations resulting from any pre- *or* post-petition judgment, consent order, decree, settlement or similar penalty.[58]

SOX is a product of the implosion of widespread corruption schemes fueled by the malfeasance of corporate senior management. Significantly, the statute embodies the congressional view that securities law reform was essential to bulk-up corporate governance and curb the financial abuses made evident when the conduct of corporate directors and officers was exposed in the early 2000s. While the judicial branch lacks the institutional ability to enact such sweeping and clearly-intentioned rules of law, post-Enron jurisprudence illustrates a strong attempt by the judiciary to ensure the liabilities of a debtor's senior management are not so readily forgiven through a chapter 11 plan.

Post-Enron Courts Apply Heightened Scrutiny to Third-Party Releases

Today, the discord among Circuit Courts can still be attributed to each Circuit's perspective on the statutory interplay between section 524(e) and section 105(a). For clarity's sake, the changing trend of the courts has not manifested itself in a departure from these general overarching legal principles or from the precedent interpreting statutory authority (i.e. a switch from the Permissive to Prohibition view). Rather, the trend is illustrated more subtly — in the judicial gloss of the increasingly restrictive application of the fluid standards within the Permissive Circuits.

For this reason, a detailed focus on the facts of opinions from Prohibition Circuits is unnecessary. The Prohibition Circuits read section 524(e) as a limitation on section 105(a), and thus, cannot (except in extraordinary circumstances) approve third-party releases consistent with the principle of *stare decisis*. Therefore, the analysis of the trend toward the increasingly restrictive judicial view of third-party releases is focused predominantly on the Permissive Circuits, where judges exercise discretion in applying subjective balancing tests. The Permissive Circuits are governed by the subjective, equitable balancing tests from which the judiciary's true objectives can be gleaned.

Post-Enron Courts: Prohibition Circuits

During the post-Enron period, the Fifth Circuit[59] has joined the ranks of the Ninth and Tenth Circuits, which hold the minority view that the statutory language of section 524(e) provides a strict prohibition against third party releases. While the Fifth Circuit's ruling is not a departure from prior precedent to the contrary, the decision to side with the minority Prohibition Circuits with respect to a matter of first impression is illustrative of the judicial climate following the corporate scandals of the early 2000s.

Post-Enron Courts: Permissive Circuits

Courts in the Second,[60] Third,[61] Fourth,[62] Sixth,[63] Seventh,[64] and Eleventh[65] Circuits consistently agree that section 524(e) is not an explicit limitation on the courts' section 105(a) equitable powers. The post-2000 division between Prohibition and Permissive Circuits clearly does not mark a significant change in third-party release precedent. However, a focus on the courts' application of the standards illustrates the movement of the Permissive Circuits towards a more restrictive view.

Sixth Circuit

In *Dow Corning Corporation*,[66] the Sixth Circuit enumerated seven elements for courts to consider in determining whether to approve third-party releases. These include whether: (1) there is an identity of interests between the debtor and the third party; (ii) the non-debtor has contributed substantial assets to the reorganization; (iii) the injunction is essential to reorganization; (iv) the impacted class, or classes, has overwhelmingly voted to accept the plan; (v) the plan provides a mechanism to pay for all, or substantially all, of the class or classes affected by the injunction; (vi) the plan provides an opportunity for those claimants who choose not to settle to recover in full; and (vii) the bankruptcy court made specific factual findings.[67] When viewed collectively, the consideration of these factors begins to approach the concept of a consensual release.

Although the *Dow Corning* decision does not mark a 180-degree departure from a broader pre-2000 Sixth Circuit decision, it does reverse a pre-2000 Eastern District of Michigan decision approving the releases.[68] The essence of the court's decision is that third-party releases constitute extraordinary relief only available in unique circumstances which require specific explanations and detailed evidence in support of the findings. The Sixth Circuit

55 *Id.* at 1524 n. 7.
56 *Id.* at 1523.
57 *Id.* at 1527.
58 11 U.S.C. § 523(a)(19).

59 *In re Pac. Lumber Co.*, 584 F.3d 229, 253 (5th Cir. 2009); *see also In re Vitro S.A.B. DE C.V.*, 701 F.3d 1031, 1061 (2012) (noting prior Fifth Circuit precedent "seem[s] broadly to foreclose non-consensual non-debtor releases in permanent injunctions").
60 *In re Metromedia Fiber Network, Inc.*, 416 F.3d 136 (2d Cir. 2005) (determining that 11 U.S.C. § 105(a) permits courts to approve third-party releases in "unique" circumstances).
61 *In re Washington Mut., Inc.*, 442 B.R. 314, 352 (D. Del. 2011).
62 *Nat'l Heritage Found., Inc. v. Highbourne Found.*, 760 F.3d 344 (4th Cir. 2014) cert. denied, 135 S. Ct. 961, 190 L. Ed. 2d 833 (2015).
63 *In re Dow Corning Corp.*, 280 F.3d 648, 657-58 (6th Cir. 2002).
64 *In re Airadigm Commc'ns, Inc.*, 519 F.3d 640, 656 (7th Cir. 2008) ("In any event, § 524(e) does not purport to limit the bankruptcy court's powers to release a non-debtor from a creditor's claims.").
65 *In re Seaside Eng'g & Surveying, Inc.*, 780 F.3d 1070, 1078 (11th Cir. 2015).
66 *In re Dow Corning Corp.*, 280 F.3d 648 (6th Cir. 2002).
67 *Id.* at 658.
68 *See generally, In re Dow Corning Corp.*, 255 B.R. 445, 459 (E.D. Mich. 2000) *aff'd and remanded*, 280 F.3d 648 (6th Cir. 2002).

held the third-party releases were impermissible because the "bankruptcy court provided no explanation or discussion of the evidence underlying these findings. Moreover, the findings did not discuss the facts as they related specifically to the various released parties, but merely made sweeping statements as to all released parties collectively."[69]

The sentiment expressed by the Sixth Circuit in denouncing the use of conclusory statements, mandating specific evidentiary findings, and requiring separate analyses of individual releasees set the stage for the expectations of subsequent post-2000 third-party release decisions across the Circuits.

Second Circuit

The Second Circuit's favorable disposition toward broad third-party releases as established in *Johns-Manville* in 1988 began to recede with its subsequent opinion in *In re Metromedia Fiber Network, Incorporated*.[70] In *Metromedia*, the Second Circuit held the bankruptcy court's findings were insufficient to support the validity of the plan's nonconsensual non-debtor release, but dismissed the appeal of the releases as equitably moot, in order to avoid disturbing the plan of reorganization that had already been implemented.[71] Notwithstanding the procedural disposition, the opinion evidences the Second Circuit's movement towards accepting the *Dow Corning* factors and requiring specific factual findings and detailed evidence supporting the propriety of the releases.

Here, a trust established by insiders of the debtors offered to (i) convert $15.7 million in secured claims to equity in the reorganized debtors; (ii) forgive unsecured claims against the debtors in the amount of $150 million; (iii) invest $12.1 million in the reorganized debtors; and (iv) purchase $25 million of unsold common stock in the reorganized debtors' stock offering (the "Trust Contribution").[72] In return for the Trust Contribution, the trust and certain non-debtor insiders would receive 10.8% common stock in the reorganized debtors and obtain a broad release from "any holder of a claim of any nature . . . any and all claims, obligations, rights, causes of action and liabilities arising out of or in connection with any matter related to [the debtors] . . . based in whole or in part upon any act or omission or transaction taking place on or before the Effective Date."[73]

In evaluating whether the third-party releases were permissible, the court expressed significant hesitance regarding non-debtor releases noting "a nondebtor release is a device that lends itself to abuse . . . . In form, it is a release; in effect, it may operate as a bankruptcy discharge arranged without a filing and without the safeguards of the Code."[74]

The court emphasized that the releases protected against any debtor-related claims "whether for tort, fraud, contract, violations of federal or state securities laws, or otherwise, whether known or unknown, foreseen or unforeseen, liquidated or unliquidated, fixed or contingent, matured or unmatured."[75] The Second Circuit pointed out the District Court's failure to inquire whether such broad releases, including a discharge for noncontributing parties, were actually necessary to the plan. The court went on to note that the lower court's only justification for granting the third-party releases was that the Trust Contribution was a "material contribution" to the estate.[76] A finding that the non-debtors provided a material contribution, the *Metromedia* Court held, was insufficient to satisfy the standard set out in *Drexel*, which requires a finding that the release itself was important to the plan.[77]

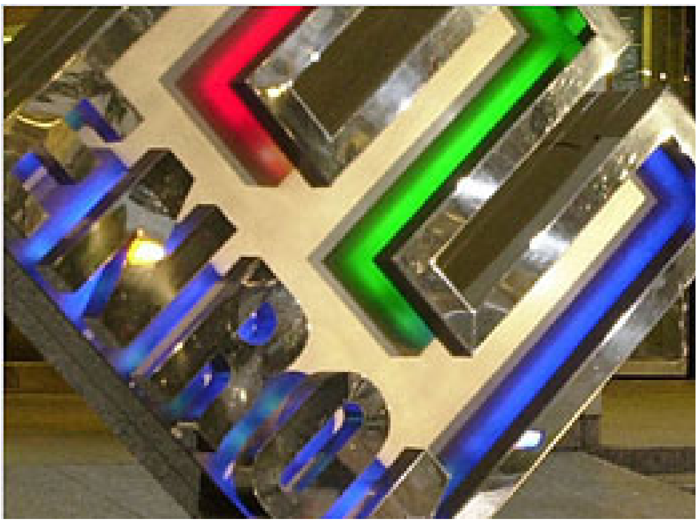
While the *Metromedia* Court cited to *Drexel* in finding the releases were impermissible, it plainly engaged in a restrictive application of *Drexel's* "importance" requirement. It would take no stretch of the judicial imagination to find a "material contribution" constitutes an important one.[78] The Second Circuit took issue with the lower court's conclusory statements regarding the propriety of the releases, and effectively decided that releases must be supported by specific details about necessity and importance. The rejection of the third-party releases for want of specificity is simply not a sentiment that can be ascribed to the *Drexel* opinion. [79]

Third Circuit

In direct contravention of the 2000 decision in *In re American Family Enterprises*, the *Washington Mutual* Court denied a third-party release in favor of noncontributing directors and officers. The court provided a separate analysis for each group of similarly situated non-debtors, explaining that a specific analysis of the breadth of the non-debtor releases is necessary, both with respect to the parties and the claims being released. The Court applied the *Master Mortgage* factors,[80] noting first that a director or officer's potential indemnification claim against a debtor is simply an insufficient ground for a release, and that to hold otherwise would, in effect, "justify releases of directors and officers in every bankruptcy case."[81] Next, the court discredited the debtors' assertion that the plan was overwhelmingly accepted by creditors, noting that the fact that creditors would be receiving payment in full was irrelevant to the analysis concerning directors and officers because they made no contribution.[82]

The *Washington Mutual* Court's departure from prior decisions within the Third Circuit favoring incidental releases for noncontributing parties illustrates the heightened judicial awareness of the serious issues with respect to releasing a debtor's senior management without engaging in a complete analysis of the value of each party's contributions to the plan. It is noteworthy that significant securities litigation against Washington Mutual directors and officers was pending during the chapter 11 case.

69 *Id.*
70 *In re Metromedia Fiber Network, Inc.*, 416 F.3d 136 (2d Cir. 2005).
71 *Id.* at 144.
72 *Id.* 141.
73 *Id.*
74 *Id.* at 142.
75 *Id.*
76 *Id.* at 143.
77 *Id.*
78 *See* Black's Law Dictionary (10th ed. 2014) (defining "material" (in the context of a material fact) as one that is significant or essential to the issue or matter at hand; esp., a fact that makes a difference in the result to be reached in a given case").
79 *See supra* Section III. B. 1.
80 In *In re Master Mortgage Inv. Fund, Inc.*, 168 B.R. 930, 935 (Bankr. W.D. Mo. 1994), the court cited to several courts that embraced the permissive view of third-party releases, including *A.H. Robins* and *Manville*, and pulled together several factors considered by those courts. The five non-exhaustive *Master Mortgage* factors include whether: (1) there is an identity of interest between the debtor and the third party, usually an indemnity relationship, such that a suit against the non-debtor is, in essence, a suit against the debtor or will deplete assets of the estate; (2) the non-debtor has contributed substantial assets to the reorganization; (3) the injunction is essential to reorganization. Without it, there is little likelihood of success; (4) a substantial majority of the creditors agree to such injunction, specifically, the impacted class, or classes, has "overwhelmingly" voted to accept the proposed plan treatment; (5) the plan provides a mechanism for the payment of all, or substantially all, of the claims of the class or classes affected by the injunction. *Master Mortgage*, 168 B.R. at 935.
81 *In re Washington Mut., Inc.*, 442 B.R. 314, 349 (Bankr. D. Del. 2011).
82 *Id.* at 350.



Significantly, other post-Enron cases within the Third Circuit denied third-party releases for similar reasons.[83] Recent cases from the Third Circuit also confirm the continued application of increasingly tight standards for approving third-party releases: "the plan's proponent must demonstrate that there is a relationship between the debtors' successful reorganization and the non-consensual parties' release, and that the releasees have provided a critical financial contribution to the debtors' plan that is necessary to make the plan feasible in exchange for receiving a release of liability."[84]

Fourth Circuit

In 2014, the Fourth Circuit issued an opinion that marked a substantially narrow interpretation of the third-party release standards set out by prior Fourth Circuit precedent in *A.H. Robins*.[85] The *National Heritage* Court denied third-party releases that would enjoin claims against the debtor's directors and officers where application of the Sixth Circuit's *Dow Corning* factors[86] resulted in the satisfaction of only one factor. The court held (i) the releasees made no substantial financial contribution as continuing to perform debtor-related duties was not a relevant contribution; (ii) the releases were not essential because there was no evidence the plan was "doomed" without them; (iii) the creditors' support of the plan was questionable because the class most affected by the releases was ineligible to vote; (iv) the plan provided no mechanism to pay for the classes affected by the release; and (v) there was no opportunity for non-settling parties to recover in full.[87]

The Fourth Circuit's analysis, specifically with respect to factor (ii) above plainly demonstrates its disfavor for third-party releases. The court explained that although there was an identity of interest between the debtor and its directors and officers, there was no evidence the debtor faced "a strong possibility of suits that would trigger its indemnity obligation, much less that such suits would threaten its reorganization."[88] Thus, the releases were not essential. The court did not elaborate on its evaluation of risk with respect to the potential future litigation, other than noting the debtor did not provide sufficient evidence of further litigation.

Seventh Circuit

The Seventh Circuit's 2008 decision in *Airadigm*, which approved the release at issue in that case, may be misunderstood as an outlier with respect to the trend toward limiting third-party releases.[89] However, upon closer review, it is important to note that the release approved by the *Airadigm* Court was actually an exculpation clause. As mentioned *supra* section II, exculpation clauses are generally far narrower in both the type of actions released and the subject matter of the releases.[90] Also notable is that the third-party seeking the benefits of the exculpation clause contributed approximately $221 million towards the debtor's plan.

Eleventh Circuit

This year, the Eleventh Circuit confirmed a plan of reorganization containing third-party releases in favor of former principals of the debtor who would act as key employees of the reorganized debtor.[91] The releases were approved even though the only contribution offered by the principals was their labor.[92] Significantly, the language of the opinion suggests the judge's ruling was a product of his complete exasperation with the litigation at hand: "[t]his case has been a death struggle, and the non-debtor releases are a valid tool to halt the fight."[93] The *Seaside Engineering* decision represents an outlier with respect to the trend toward strict judicial application of third-party release tests, for reasons seemingly admitted within the opinion.

Conclusion

The group of pre-Enron opinions on third-party releases is comprised of only two Circuits holding the prohibitive view — the most restrictive view of third-party releases. Further, the opinions authored by Permissive Circuits illustrate a strong inclination toward approving third-party releases with remarkably

83 *In re 710 Long Ridge Rd. Operating Co., II, LLC*, No. 13-13653 (DHS), 2014 WL 886433, at *18 (Bankr. D.N.J. Mar. 5, 2014) ("Simply put, the record is devoid of proof the individuals seeking to be released have made a necessary contribution toward funding the Plan and, even under the extreme circumstances of this case, without such demonstration, the proposed releases to managers, director, officers, or employees is not warranted and cannot be approved."); *In re Lower Bucks Hosp.*, 488 B.R. 303, 325 (E.D. Pa. 2013) *aff'd*, 571 F. App'x 139 (3d Cir. 2014 (third-party release disallowed with respect to noncontributing releasee); *In re Coram Healthcare Corp.*, 315 B.R. 321, 336 (D. Del. 2004).

84 *In re Lower Bucks Hosp.*, 488 B.R. 303, 323 (E.D. Pa. 2013) *aff'd*, 571 F. App'x 139 (3d Cir. 2014) ((quoting *In re Nickels Midway Pier, LLC*, No. 03–49462, 2010 WL 2034542, at *13 (Bankr. D.N.J. May 21, 2010) (quoting *In re Genesis Health Ventures, Inc.*, 266 B.R. 591, 608 (Bankr. D. Del. 2001)); *see also In re Combustion Eng'g, Inc.*, 391 F.3d 190, 236-37 (3d Cir. 2004), *as amended* (Feb. 23, 2005) (vacating a section 105(a) injunction of independent claims against non-debtor parties noting "the general powers of § 105(a) cannot be used to achieve a result not contemplated by the more specific provisions of § 524(g) [the subsection of § 524(g) which specifically allows third-party releases of parties co-liable with the debtor for derivative asbestos-related claims]).

85 *Nat'l Heritage Found., Inc. v. Highbourne Found.*, 760 F.3d 344, 351 (4th Cir. 2014) *cert. denied*, 135 S. Ct. 961, 190 L. Ed. 2d 833 (2015).

86 The court seems to have omitted the seventh factor concerning the specificity of the bankruptcy court's findings.

87 *Nat'l Heritage Found.*, 760 F.3d at, 348-51 (4th Cir. 2014).

88 *Id.* at 351.

89 *See Circuits Differ on Nonconsensual Nondebtor Releases*, 49 No. 17 Bankr. Ct. Dec. News 3, April 1, 2008 (classifying the releases as "third-party releases" and not exculpation provisions; Brief of National Labor Relations Board at 20 n. 18, *In re 710 Long Ridge Road Operating Company II, LLC, et al.*, No. 13-13653 (D.N.J. March 5, 2014) ECF No. 854 (while the NLRB did classify the exculpation correctly, it did not point out the significance in the distinction between exculpation provisions and third-party releases).

90 *In re Airadigm Commc'ns, Inc.*, 519 F.3d 640, 657 (7th Cir. 2008) ("First, the limitation itself is narrow: it applies only to claims arising out of or in connection with the reorganization itself and does not include willful misconduct. This is not blanket immunity for all times, all transgressions, and all omissions. Nor does the immunity affect matters beyond the jurisdiction of the bankruptcy court or unrelated to the reorganization itself.") (internal citations and quotations omitted).

91 *In re Seaside Eng'g & Surveying, Inc.*, 780 F.3d 1070, 1079 (11th Cir. 2015).

92 *Id.* at 1080.

93 *Id.* at 1081.

broad injunctive language. Courts deciding the *A.H. Robins*, *In re American Family Enterprises*, and *Monarch Life Insurance Company* cases approved third-party releases in favor of parties who offered no plan contribution in return. Moreover, pre-Enron courts applied no specific judicial standard, and in most cases, briefly addressed the importance of the releases to reorganization. The propriety of the third-party releases in most cases was evaluated through a collective analysis of all releasees, despite extreme differences in circumstances among the parties. The courts' conclusions did not require any actual evidentiary record for the necessity of third-party releases.

Post-Enron, the Fifth Circuit joined the ranks of the Prohibition Circuits, notwithstanding that the prohibition view is the minority in the circuit split. Starting with the Sixth Circuit's bold expression of disapproval toward conclusory opinions supporting third-party releases, the Permissive Circuits have established a pattern of applying heightened judicial scrutiny and rigorous standards, often referring to non-debtor releases as extraordinary relief. The most cited post-Enron circuit court rulings on third-party releases include thoughtful analyses which reference specific factual evidentiary findings, and include separate evaluations of individual releasees not similarly situated.

Significantly, SOX reform prohibiting an individual debtor from a discharge of his securities-fraud-related debts endorses even further the sentiment that the Bankruptcy Code should not permit third-party releases in favor of non-debtors — and especially corporate directors and officers — without a thorough analysis supported by evidentiary proof that illustrates the propriety of the releases. It is, indeed, difficult to square circumstances where an officer or director can obtain relief in a chapter 11 context involving his employer but is not eligible for such relief in his own bankruptcy proceeding. Numerous other recently proposed reforms have put a spotlight on the need to retract the judicial extension of Bankruptcy Code benefits to parties undeserving of such protection.

For example, the ABI Commission Report released in December 2014 proposes that nonconsensual third-party releases be deemed enforceable, subject to the balancing of five factors — all of which were seen and analyzed at great length by post-Enron courts. The five factors proposed by the ABI Commission include: (i) the identity of interests between the debtor and the third party, (ii) the value contributed by the third party; (iii) the necessity of the release to facilitating the plan of reorganization; (iv) creditor support for the plan; and (v) the payments and protections otherwise available to creditors affected by the release.[94] The Commission's suggested mandate, if adopted, ensures a departure from conclusory opinions and broad allowance of third-party releases.

Emerging from the remaining uncertainty of judicial precedent that comprises the law of third-party releases is one certainty. The post-Enron judiciary has begun to establish a trend toward limiting broad third-party releases, except under unique circumstances or precluding them altogether, especially in favor of a corporate debtor's directors and officers. Whether a work of the judicial subconscious or a response stemming from a renewed or heightened awareness; the pendulum has swung in the wake of the massive corporate malfeasance unearthed in the early 2000s.

94 Jay M. Goffman, et al., *Overview of the ABI Commission Report and Recommendation on the Reform of Chapter 11 of the Bankruptcy Code*, December 23, 2014, at 11.

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