AIRA | Association of Insolvency & Restructuring Advisors

Journal

VOL. 29 NO. 4 -2015

Results of Retail Bankruptcy Study:

Plan or Perish

By James Hogarth and Holly Felder Etlin, CIRA

What's Inside:

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Note: In AIRA Journal Vol. 29 No. 2, p.12, and Vol. 29 No. 3, pg. 17, Andrew Masini's title was erroneously reported as Managing Partner instead of Senior Manager.

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Michael Lastowski - Editor
Valda Newton - Managing Editor
Michael Stull - Creative Director

THOMAS MORROW, CIRA
AlixPartners, LLP

A Busy Quarter of Activity

We have had a number of great events in the past 90 days and there are more coming soon in the first quarter of 2016. On September 16, AIRA and the Southwest Chapter of CFA sponsored the 4th Annual Energy Summit in Dallas, where over 100 attendees benefited from a high level day focused on the energy industry. On September 27 AIRA hosted the National Conference of Bankruptcy Judges opening reception for 1,700 attendees – one of the premier networking events of the year for bankruptcy and restructuring advisors. Also in conjunction with the NCBJ, AIRA presented a breakfast with panel discussion of restructuring solutions for mass tort cases. On November 2, AIRA's 14th Annual POR conference in New York took place with a reception honoring Judge Robert Drain, recipient of the 2015 Judicial Service Award.

During the last quarter of 2015 we also offered a full schedule of CIRA training including CIRA Parts 3 and 1 in New York and CIRA 2 and 3 in San Juan PR. In August and September, the CIRA 3 course was also conducted online – if you can't come to a traditional course for CIRA training, the course can come to you! See www.aira.org for the 2016 course schedule.

We continued to have a steady offering of Webinars in the fourth quarter: Commercial and Tribal Gaming (October 28); Critical Decisions for E&P When the Clock is Ticking (November 4); Challenging Regulations in Post-Secondary Education (November 18); Asset Based Lending – Nuts, Bolts and Industry Trends (December 16). Webinar programs are very timely and are offered as new information hits the market, so check www.aira.org and Weekly Advisor emails for new programs. If you miss a webinar, they are made available on the website as self-study courses for CPE credit.

What's Coming Up?

In the upcoming quarter there will be several exciting events. On January 19, AIRA will again co-host a one day educational event with the New York Institute of Credit. On March 14-16 we will be in Las Vegas for VALCON 2016, co-hosted by AIRA with the American Bankruptcy Institute and University of Texas Law School. We will also be starting a new round of CIRA classes, starting in February with an online presentation of CIRA 1 (followed by Parts 2 and 3 in April and July). CIRA 3 will be offered as a live group class in March 1-3 in New York. See AIRA's website for more courses.

Meet the Stars

All of these terrific educational opportunities can only happen through the hard work of the dedicated staff in Medford, OR. Many of you have met some of these individuals but I want to give them the recognition they deserve.

Terry Jones – Terry is the longest tenured staff member, joining AIRA in May of 2001. As Director of the CIRA and CDBV programs, Terry manages all aspects of candidate registration, requirements tracking and course arrangements.

Michael Stull – Mike was hired in March 2014 to carry out AIRA's IT, database and creative functions. The web site, especially the AC15 website, AIRA Journal and weekly emails reflect Mike's work. A DJ in his "other" life, Mike applies his radio experience to managing AIRA's live webcasts of courses and webinars.

Elysia Harland – As AIRA's controller, Elysia has managed the books for AIRA since April 2009. She prepares financial statements and handles billing, payments, payroll and tax returns among others.

Michelle Michael – Since February 2010 Michelle has managed new and renewed memberships, CPE certificates, CPE requirements for CIRAs, and conference support including onsite registration at Annual Conferences.

Mary Hamilton – Hired in September 2010, Mary serves as administrative assistant for most functional areas, especially with self-study and book orders, conference support and reception desk.

Valda Newton – Working with Grant for many years as part of the AIRA team, Valda serves as managing editor of AIRA Journal, prepares and edits website content and promotional communications, and provides conference support.

Also, we are pleased to have Certified Meeting Planner, ***Cheryl Campbell*** (based in Denver, CO), working with AIRA since January 2013 to put together the detailed arrangements that go into AIRA's educational conferences.

Please join me in thanking the staff of AIRA for all the hard work they put into making the organization successful.

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Moderator, Jay Goffman, Global Head of Corporate Restructuring, *Skadden, Arps, Slate, Meagher & Flom LLP and Affiliates*

Honorable Robert D. Drain, Bankruptcy Judge, *U.S. Bankruptcy Court, Southern District of NY*

James Sprayregen, Partner, *Kirkland & Ellis LLP*

Allen Wilen, CIRA, Partner, *EisnerAmper LLP*

SESSION 2 -PLAN SUPPORT

Moderator, Andrew Silfen, Managing Partner, Arent Fox LLP

Honorable Kevin Gross, Bankruptcy Judge, U.S. Bankruptcy Court, District of Delaware

AGENDA:

11:00am Registration & Networking
11:30am Session I
12:45pm LUNCH
1:15pm Session II

1.5 CPE CREDITS WILL BE AVAILABLE PER SESSION

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Results of Retail Bankruptcy Study: Plan or Perish

BY JAMES HOGARTH & HOLLY FELDER ETLIN, CIRA
AlixPartners, LLP

In most industries, bankruptcy is an uncomfortable and expensive process, yet only about one in 20 non-retail U.S. corporate bankruptcies actually result in the worst scenario of all: liquidation.[1] In the retail industry, however, the picture is very different- since January 2006, 47% of all resolved retail bankruptcy filings have ended in liquidation.[2]

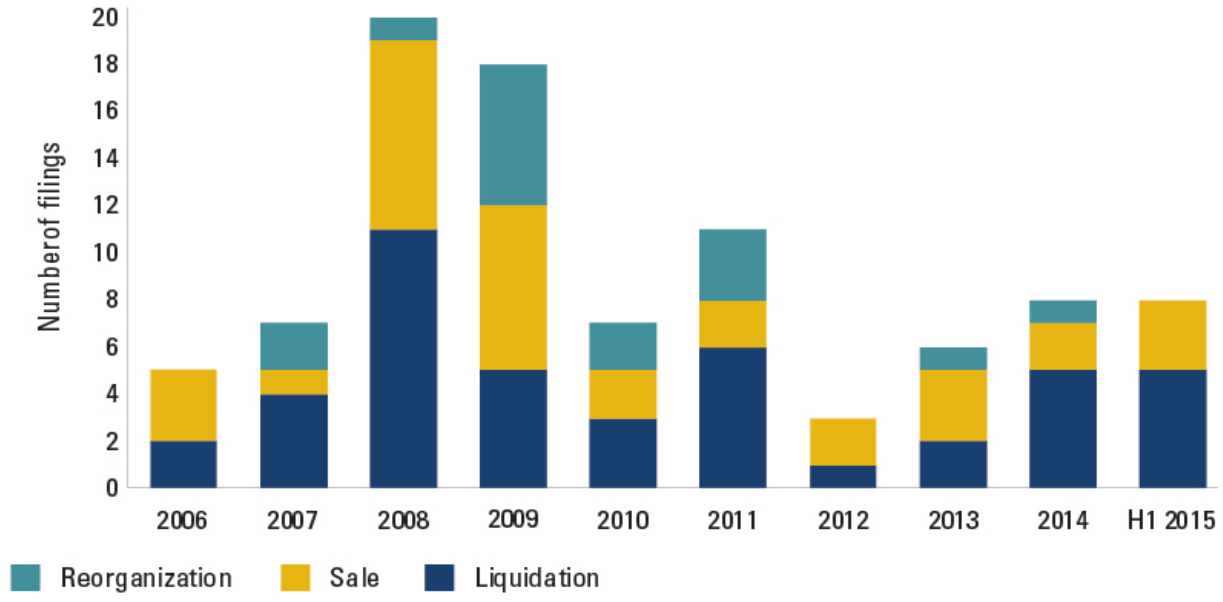
This article summarizes the findings from an AlixPartners study of 93 retail bankruptcies since 2006 with over $50 million in liabilities to explore how and why retailers struggle in bankruptcy (See Exhibit 1). While the 2005 changes to the Bankruptcy Code represent the single largest challenge to bankrupt retailers, the difficulty of reading the warning signs, creating a turnaround plan that goes deep enough, and locking in support for a restructuring plan in advance of a filing have also contributed to the incredibly high level of retail liquidations. By effectively dealing with these issues in the planning stage, retailers can improve the odds for a successful turnaround to more than a 50-50 proposition.

Why Do So Many Retailers Fail in Bankruptcy?

That retailers struggle in bankruptcy is hardly a point of debate. Results of a study by AlixPartners released in November 2015[3] show that only 49 of 93 retailers emerged from Chapter 11 as going concerns. Furthermore, thirteen of the apparently successful emergences subsequently re-entered bankruptcy (often called "Chapter 22" or "Chapter 33"). Ultimately, a staggering 55% of retail Chapter 11 filers in the study ended in liquidation. Data from the most recent 18 months reveal little sign of improvement during the recovery – during this time only 6 debtors successfully reorganized or were sold, while 10, or 62.5%, were liquidated.[4]

The reasons that retailers struggle in bankruptcy are complex and varied. The liquid nature of retail inventory has always provided a high bar over which a retailer must jump to reorganize because it increases the attractiveness of liquidation. However, the 2005 changes to the federal Bankruptcy Code were a game changer. In addition to expanding the "administrative priority" status for

EXHIBIT 1 – Retail Bankruptcy Outcomes by Filing Year
(Adjusted for repeats, January 2006 to June 2015)



[1] Fitch Ratings, April 2013. Based on a bankruptcy case study with database of 86 total U.S. corporate bankruptcy cases, including 14 liquidations; 20 cases and 11 liquidations were retailers.

[2] AlixPartners' analysis includes all resolved retail bankruptcy filings between 1/1/2006 and 6/30/2015 with over $50 million in liabilities; restaurants and grocers were excluded. Repeat filings were included even if liabilities were below $50 million in the second filing.

[3] Results of AlixPartners' study were originally published at http://www.alixpartners.com/en/Publications/AllArticles/tabid/635/articleType/ArticleView/articleId/1795/AlixPartners-Retail-Bankruptcy-Study.aspx#sthash.eXwachVL.dpbs

[4] The period of 18 months was from 1/1/14 to 6/30/15.

EXHIBIT 2 – Challenges to Retailers in Bankruptcy

Liquid Assets - To emerge from bankruptcy, a debtor company must pass the "best-interests" test, proving that each class of creditor does better under a Plan of Reorganization than if the company liquidated. This test generally provides a much higher bar for retailers than for other debtors for two reasons. First, retailers tend to have highly liquid inventory, in contrast to the high proportion of fixed assets that characterize many other industries. For example, inventory as a percentage of total assets can be as high as 40% even at healthy retailers. Secondly, retail inventory typically retains its value well in bankruptcy and benefits from a well-capitalized industry of players prepared to manage liquidations for debtors or purchase inventory at auction. For example, liquidators paid 111% of cost for Anna's Linens inventory in 2015 and 97% for Coldwater Creek's in 2014.

503(b)(9) Vendor Claims - As part of the 2005 Bankruptcy Code changes, the claims of vendors for the value of goods sold in the 20 days immediately preceding a bankruptcy filing now get "administrative priority" status, which means those claims must be paid in cash upon the effective date of a plan. This represents a significant hurdle to the emergence of many retailers. For example, Circuit City's 2008 slide into liquidation was certainly hastened by the $350 million of 503(b)(9) claims that were filed with the court.

certain trade goods received in the run-up to a filing – see the description of 503(b)(9) Vendor Claims in Exhibit 2 – the changes have served to shorten the time retailers can expect to spend in bankruptcy. It is this limit to the period of time available for retailers to operate with court protection that is the most significant and burdensome of the 2005 changes – and the one which most highlights the critical need for advance preparation.

What Is All the Rush About?

Prior to the 2005 Bankruptcy Code changes, retailers often spent several years in bankruptcy – time during which they could attempt to fix the underlying causes of their predicaments. (See Exhibit 1) Frequently, such fixes included changes in merchandising strategy that allowed retailers to test their new ideas and better determine which money-losing locations could be turned around and which needed to close. This was changed in 2005 by the 2005 Act through revisions to Section 365(d)(4) of the Code, providing a maximum of just 210 days before un-assumed leases (including retailers' store leases) are deemed rejected, absent individual landlord approval to extend this deadline. It seems obscure, but this has had a huge influence for three primary reasons:

- Rejecting leases before they are assumed creates a general unsecured claim on the estate that sits below senior lenders, who typically drive the restructuring process. However, rejecting leases after they are assumed creates an administrative claim that sits above these lenders. As such, senior lenders will tend to enforce a timeline that ensures adequate time to reject all unwanted leases well in advance of the 210-day deadline in order to minimize administrative claims.
- Running in-store going-out-of-business (GOB) sales is typically the most effective way of maximizing the liquidation value of inventory. As a result, senior lenders frequently attempt to force a decision on whether to liquidate or reorganize a debtor well in advance of the 210-day deadline so that there is plenty of time to conduct in-store liquidations before leases must be assumed/rejected.
- Finally, the sale of leases can be a significant source of cash for the estate. As such, lenders today often want sufficient time to ensure an adequate marketing process for unwanted leases in advance of the 210-day deadline.

Once a retailer files for bankruptcy the clock is ticking – fast. A retailer has only a few months to obtain approval for a compelling plan for a sale or reorganization, or its lenders are likely to force the company straight into liquidation. To put this accelerated timeline in perspective, according to court documents, when Ritz Camera filed for bankruptcy on June 22, 2012, the provisions of its debtor-in-possession loan required it to have a stalking-horse bidder (an initial bidder chosen by the debtor to buy its assets ahead of a possible auction) by August 16 (just 55 days later), an auction by September 6 (76 days later) and a sale complete by September 14 (84 days later). The alternative: begin store closures immediately. In fact, of the fifteen "full" reorganizations in the AlixPartners study (the other 33 going concerns took the form of a 363 Sale), only Nebraska Book Co., Shane Co. and Hancock Fabrics Inc. took more than 200 days between filing and plan confirmation; the other 13 reorganizations took an average of only 120 days to obtain plan confirmation.

The Importance of Planning

If a retailer can expect only three or four months in bankruptcy at best before momentum inevitably shifts towards liquidation, pre-bankruptcy-petition planning is imperative. The simple reality is that the time afforded to retailers in bankruptcy is inadequate to either implement the operational fixes required or to galvanize the support required for reorganization or a sale. On the other hand, although the bankruptcy timeline itself has become compressed, bankruptcies remain the cumulative result of sustained weak sales and profits and are a long time in the making. As such, distressed retailers should consider the following steps to potentially improve their prospects for a successful turnaround:

1. **Buy Time**

   The first focus for a distressed retailer should be to create as much "runway" as possible to effectuate either an out-of-court turnaround or a well-planned bankruptcy. This begins by creating a detailed understand of a company's liquidity position and should also include a thorough review of debt covenants and other triggers that lenders may have to accelerate a filing. At the same time, a retailer should also develop and implement a variety of liquidity-generating activities, exploring common areas such as vendor management, CAPEX curtailment, G&A reductions, and borrowing-base optimization to maximize the time available. This runway is important both because it provides time to negotiate a turnaround or planned restructuring and because it provides the flexibility to choose the best time to file – possibly before the winter holidays to maximize the ease of selling excess inventory, or after the holidays when retailers are likely to have more cash on hand.

2. **Be Realistic**

   Failed retail restructurings typically follow a predictable path – first a company believes it can avoid a bankruptcy filing through an amendment to its existing debt facilities, a debt refinancing, or a pick-up in sales that never materializes; then the company enters bankruptcy with a strategy to trim only the lowest-performing stores; then the company announces that a reorganization couldn't be orchestrated and that GOB sales will be run at all stores. Perhaps the most important element of a successful turnaround is developing a truly feasible plan from the start. If there is a prospect of achieving an out-of-court turnaround, a strategy based upon store closures, marketing optimization, and merchandizing transformation may be appropriate. However, if a filing appears unavoidable, it may be better to preserve the cash needed to achieve these changes to fund an in-court turnaround.

3. Understand the Market

Understanding the capital-markets options that are available should be a key part of planning. The pool of potential investors for a distressed retailer is typically small, and it is vital to begin dialogue with these investors well in advance of a filing. As part of this dialogue, a retailer should develop a clear restructuring plan that demonstrates the sustainability of its core business as a going-concern. As time goes on, retailers should also be sure to consult existing lenders to explore the potential structure of debtor-in-possession (DIP) financing and to assess the lenders' appetite to support reorganization. The goal is to secure either a stalking-horse bidder or support for a pre-arranged plan by the point of filing. The importance of this is clear from successful reorganizations included in the AlixPartners study: every successful reorganization of a debtor with over $500 million in liabilities was based on either a pre-arranged or a pre-negotiated plan.

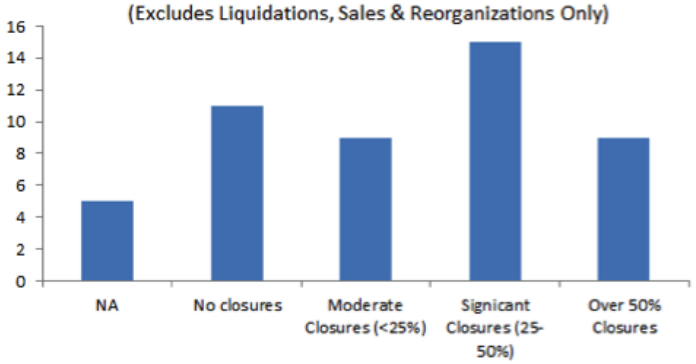
4. Focus on Operations

Even under the reduced timeline imposed in 2005, the bankruptcy process still provides many valuable and otherwise unavailable tools for retailers to rehabilitate themselves. The ability to reject store leases is perhaps the most frequently used of these, and almost every successful restructuring in our study made use of this tool. See Exhibit 3. Of 44 store-based retailers that emerged as a going concern (five of the 49 going concerns were online or catalog based retailers), 33 closed stores in bankruptcy while some of the other 11 made use of bankruptcy to clean up "lease hangovers" from pre-bankruptcy store closures. In fact, 9 retailers in the study closed more than 50% of their locations and an additional 15 closed over 25%.

Given the limited time available in bankruptcy to conduct a typical "4-Wall" cost analysis, careful consideration should be given to store closures well in advance of the filing, and a clear plan for store closures should be ready at filing. In many instances, it will also be appropriate to begin rent negotiations with landlords against the backdrop of a potential filing to extract potential savings and ensure decisions on whether to retain or close a store are made with an understanding of potential go-forward lease expense. In addition to store closures, the ability to reject other executory contracts provides a powerful tool for renegotiating and improving marketing, logistics, transportation, and other third-party agreements.

EXHIBIT 3 – Extent of Store Closures in Bankruptcy

(Excludes Liquidations, Sales & Reorganizations Only)



Plan, Don't Perish

Retail is a tough business, but recognizing this and being prepared for a potential bankruptcy makes it less likely to be unforgiving. Continued spotty consumer demand, rising labor costs and the relentless march of e-commerce continue to drive some retailers towards bankruptcy long after the Great Recession shocked retail like it had not been shocked for decades. Add the revised Bankruptcy Code and the short runway provided for by most debtor-in-possession financings, and it means bankruptcy is not the refuge it once was. Nevertheless, almost half of all retailers in the study emerged as going concerns, and others may take away from their experience the following keys to survival: begin planning long before the bankruptcy filing date, file with either a stalking-horse bidder or pre-arranged plan, and embrace a restructuring that includes significant operational improvement.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of AlixPartners, LLP, its affiliates, or any of its or their respective other professionals or clients.

ABOUT THE AUTHORS

JAMES HOGARTH

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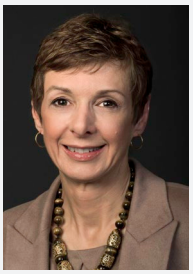
James is a Director in AlixPartners' Turnaround & Restructuring Services practice. He has more than 12 years of experience in corporate restructurings, re-organizations and business operations and has worked on a variety of in-court and out-of-court retail turnarounds in the home furnishings, toy, media, grocery and restaurant industries. He has an MBA from the Wharton School, at the University of Pennsylvania, a BA and MA from Oxford University and is a member of the Turnaround Management Association.



HOLLY FELDER ETLIN, CIRA

Managing Director | AlixPartners LLP

Holly is a Managing Director in AlixPartners Turnaround and Restructuring practice. She is a seasoned executive with 30 years of experience in providing restructuring and reorganization services for companies and their creditors in the retail, media, distribution, consumer products, financial services, and healthcare industries. In 2007, the Turnaround Management Association recognized Holly with its Turnaround of the Year Award for the successful restructuring of Winn-Dixie Stores, Inc. In 2014, Holly was named "Woman of the Year in Restructuring" by the International Women's Insolvency and Restructuring Confederation (IWIRC), an international networking and professional growth organization for women in the restructuring and insolvency industry.

Hon. Robert Drain Receives 2015 Judicial Service Award

Left to right: Andrew Silfen (ArentFox LLP), Hon. Robert D. Drain, Tom Morrow (AIRA President)

On November 2, at the conclusion of AIRA's Advanced Restructuring and POR Conference, the 2015 Judicial Service Award was presented to the Honorable Robert Drain, United States Bankruptcy Judge for the Southern District of NY. Judge Drain was chosen by AIRA's Board to receive the award in recognition of his outstanding and sustained contributions and dedication to the bankruptcy and restructuring community.

Judge Drain has the unique ability to craft solutions for big problems or disputes and bring parties together to find common ground and reach compromises. Since his appointment he has presided over many major cases, including: Refco, Momentive, A&P, Fortunoff, Hostess Brands, Coudert Brothers, Readers Digest, Delphi Corp., Star Tribune and Frontier Airlines. These examples illustrate the diversity and significance of the cases over which he has presided. Judge Drain has also served as a judicial mediator and facilitated resolutions in large, complex and often litigious cases. In addition, he has been an active supporter and speaker at AIRA conferences, fellow of the American College of Bankruptcy and a member of ABI, the International Insolvency Institute, and the National Conference of Bankruptcy Judges, among others. He is an adjunct professor at St. John's University School of Law and has lectured and written on numerous bankruptcy-related topics.

The Judicial Service Award recognizes Judge Drain's outstanding contribution to the Bankruptcy and Restructuring profession and community and years of service as a member of the judiciary. He is recognized as an exceptional Judge and inspiration to colleagues on the bench, bankruptcy lawyers and other professionals. In remarks at the award ceremony, AIRA director Andrew Silfen commended Drain's wide ranging intellect, understanding and application of the law, and his commitment to fairness and due process and patience.

Didn't See That One Coming! Dealing With the Unexpected in Business

PATRICK STEWART, CIRA
Monument Advisors

Anybody who has owned or operated a business in the last few years would probably agree with the old adage that "the only constant is change." While change can be good, it can also spell trouble, and it often hits us when we least expect it.

The recession and sluggish recovery cast a wide shadow over the business community. Perhaps most obvious is the change in the retail landscape, which has been punctuated with high profile bankruptcies like RadioShack and JC Penney's continuing struggles. But the fallout is apparent in other industries, too. New forms of lending are being introduced into traditional banking, social media is infiltrating all aspects of marketing, and technology is creeping into every facet of commerce. Today's on-demand consumers are more knowledgeable, more price sensitive, expect higher standards and actively explore more new shopping platforms than ever before.

So what's a company supposed to do? After all, it's not what you see coming that hurts, it's what you don't that can bring a business to its knees.

The answers are really all around us. Everything in a business tells you something, and sometimes what you aren't seeing reveals just as much. Protecting your company starts with a detailed understanding of what's going on in the business:

- Which customers comprise 80% of profits, and is that customer base large enough so the loss of any one customer won't hurt too much?
- How do you know when something isn't working? What metrics do you look at to know when a project is off track or a department isn't getting it done?
- What systems do you have in place to monitor internal and external change? Do you regularly and systematically measure what's going on in the marketplace?
- What risks can you quantify, and what can you do about them?

Answers to these key questions will identify potential red flags. The next step is to make clear what levers you can pull in the event of unforeseen events. Here we need to take a deeper look, beyond the basic P&L, to determine what you can actually control. We may not be able to control the market chaos around us, but there are steps we can take to put internal controls in place.

Profit Analysis Beyond the Margins

Analyze true customer profitability by looking beyond gross margin. In most cases, our clients discover that their profitability is tied to fewer customers than expected, which means they are carrying more marginal, and sometimes unprofitable, customers than they thought. At that point they must choose between improving profits on certain customers or jettisoning them to improve the overall bottom line.

Bigger is Not Always Better

While bigger customers may appear profitable, sometimes they aren't quite what they seem. Are you jumping through hoops to satisfy them by cutting margins, adding to the cost of goods sold for customization, extending payment terms or holding inventory? If push comes to shove, shrinking the business can actually make it more profitable. You can learn a great deal from monitoring levels of product returns, spikes in warranty claims, and reviewing feedback from sales and customer service representatives.

Feeding the 800 Pound Gorilla

Failure to monitor true customer profitability can hurt your business in several ways. The amount of time you spend on under-performing customers is inversely proportionate to the profits they provide. In essence, as the time you spend on unproductive customers grows, your overall company profit margin falls. There is also a diminishing returns concept in play here as you find yourself spending more company resources only to achieve less profit. We tell our clients that you can't make an 800 pound gorilla bigger, but you can find a baby gorilla to nurture and grow with. In the end, focusing on the wrong customers simply because you don't have the right information leads the business towards reduced profits, which in and of itself will eventually lead to insolvency. It also makes the business more susceptible to the unforeseen shocks that can really hurt.

A Good Offense is the Best Defense

On the surface, hiccups along the way may seem like a small deal, but when a company is operating from a weak position, that small problem can suddenly become a very big deal. Probably the most volatile issue is cash management to cover a distressed situation. For smaller companies, the unexpected could be as simple as a few large invoices hitting on the same day or in the same week, and if that happens to be a payroll week, you could find yourself unable to make ends meet. It's standard procedure to be prepared to cover a few weeks of obvious expenditures such as payroll and recurring bills. But it's worth the exercise to map out inflows and outflows to uncover the nonrecurring expenses so you can create a more realistic and predictive cash flow model.

Mining Your Data

Data is one key to winning in today's business climate, but managing that data can be a challenge for even the largest companies. In my middle market world, a client was generating more than a million records of sales transactions annually that provided crucial customer information – how much, how often and what product. However, our client wasn't paying sufficient attention to the information. Instead, they chose to put into their stores what they thought the consumer wanted. The impacts of their subjective approach were far reaching including excess and obsolete inventory, disengaged customers and even rifts within the management team. Our solution was to compile all three million records and put them into a usable form that highlighted underperforming products and categories, which were then re-priced or eliminated. Anything we got rid of was sent back to the vendor for much needed cash and credits on future orders. The result of capturing the customer input and analyzing the data was higher revenue on lower inventory levels.

Metrics Matter

Without the right operating metrics, most companies become proficient at fighting fires and many assume that's just the way it will always be. A lot of service companies assume they don't need metrics, but time is a mirror

of cost. So, if your marketing campaign or architectural design work is taking longer than expected, then you are hurting your profits by running over budget. One of the best ways to determine the right metrics for your industry is to identify what key information you could analyze that would trigger corrective action. For instance, monitoring inventory levels, hours billed, or parts produced per hour all provide valuable data points that enable you to see red flags looming on the horizon. We always look at three types of metrics: throughput, effectiveness (errors) and utilization.

Throughput denotes the number of widgets processed through the system (boxes shipped, proposals developed, building plans finished).

Effectiveness metrics reflect the number of errors or changes that were required to conclude a particular process. These metrics are typically represented by a ratio that compares the number of changes to the number of items processed.

Utilization quantifies how time is used during a process. In manufacturing you see this as "up time" compared to "down time". In professional services it shows up as "hours billed." As an aside, I think industry benchmarks can be dangerous in this context as every business is different. In my opinion it's better to understand the company's metrics and work to improve them. As an example, I was at an apparel distributor's warehouse that processed 350 lines per person per day. If we had chosen this as a benchmark for another client that distributed school supplies we would never hit the goal because of product differences. The result would be a self-defeating goal that would damage morale and do more damage than good.

The Only Constant is Change

Pay attention to the world around you. Business history is littered with companies that failed to see the change around them (Kodak, Research in Motion, RadioShack). It's critical to understand how your customers shop and the psychology behind it. Mobile technology has leveled the playing field in many ways leading to impatient consumers that expect goods wherever and whenever they want. Retailers struggle to compete across multiple platforms and juggle pricing, stock and delivery pressures. Paying attention to consumer habits can reveal simple solutions such as arranging your distribution center or a store layout to drive ultimate efficiency and profitability. Commit resources to your front line by providing customer service training, and listen to your employees' valuable feedback.

It's easy to be lulled into complacency when everything appears to be going fine, but in a blink of an eye, unexpected changes can put your business into turmoil. The key is to anticipate change and manage it by truly understanding the key factors that impact your business. If you stay attuned to clues and cues all around you and thoroughly understand what's happening on the inside, it will make reacting to the outside that much easier.

ABOUT THE AUTHOR

PATRICK STEWART, CIRA
Partner | Momentum Advisors

Patrick specializes in operational turnarounds and financial restructurings. Patrick has advised companies ranging in size from several million to several billion dollars in value. He has held numerous executive management positions serving as CEO, COO, CFO and CRO of several companies. He has significant transaction experience including M&A transactions, recapitalizations and DIP financing transactions, as well as considerable experience in process improvement and streamlining operations and businesses.

Thinking of Filing an Involuntary Petition? Consider This Recent Third Circuit Ruling

MICHAEL J. RIELA
Vedder Price P.C.

In *In re Forever Green Athletic Fields, Inc.*, No. 14–3906, 2015 WL 6080665 (3d Cir. Oct. 16, 2015), the U.S. Court of Appeals for the Third Circuit held that an involuntary bankruptcy petition can be dismissed if the creditors filed that petition in "bad faith," even where the statutory requirements of Section 303 of the Bankruptcy Code for obtaining involuntary bankruptcy relief were satisfied and the debtor was generally not paying its debts as they became due.

Because a creditor may suffer significant adverse consequences if it files an involuntary petition that is later dismissed, before filing an involuntary petition against a debtor, creditors should assess the risk that their petition may be dismissed as a bad-faith filing *even if* the technical statutory requirements for involuntary petitions are satisfied. For example, courts may find that creditors who file involuntary petitions merely as a debt collection device, or who otherwise file involuntary petitions to gain an advantage over other creditors, are acting in bad faith.

Involuntary Bankruptcy Petitions Generally

In some situations, it makes sense for creditors to file an involuntary bankruptcy petition against a debtor that is generally not paying its debts as they become due. For example, it might be advisable to file an involuntary petition if the debtor is hiding assets, or if it had made preferential or fraudulent transfers that could be unwound during a bankruptcy case for the benefit of creditors. However, filing an involuntary bankruptcy petition carries potential monetary risks for the creditors who file it. If that petition is dismissed, the creditors who filed that petition (also known as petitioning creditors) may be liable to the debtor for costs and reasonable attorney's fees.[1] Additionally, if the bankruptcy court finds that the petitioning creditors filed the involuntary petition in bad faith, those creditors may also be liable for any damages proximately caused by the involuntary filing, and even punitive damages.

Section 303 of the Bankruptcy Code contains specific requirements that must be met for an involuntary bankruptcy case to proceed over an objection. These requirements include:

- Unless the debtor has fewer than 12 qualifying creditors, the involuntary petition must be filed by at least three petitioning creditors.[2]
- The claims held by each of the petitioning creditors must be non-contingent as to liability and not subject to bona fide dispute as to liability or amount.
- The total non-contingent and undisputed claims held by the petitioning creditors must exceed a certain amount (currently $15,325 in the aggregate) over the value of any liens securing the claims.
- The debtor must not be generally paying its undisputed debts as they become due.

Notably, Section 303 of the Bankruptcy Code does not specify that involuntary petitions may be dismissed for having been filed in bad faith. Thus, it may seem reasonable to believe that so long as creditors satisfy the specific requirements that are set forth in Section 303, involuntary petitions cannot be subject to dismissal. However, under the *Forever Green* decision and the other courts that follow its reasoning, that belief would be wrong. Rather, in the Third Circuit and in some other jurisdictions, there is an independent requirement that the involuntary petition not be filed in bad faith. If that requirement is not met, then costs, attorneys' fees and damages could be awarded against the petitioning creditors.

Forever Green Case Background

Ten years ago, Forever Green filed a lawsuit in Pennsylvania state court against a competitor, ProGreen, claiming that ProGreen diverted corporate assets and seeking $5 million in damages (the "Pennsylvania Action"). ProGreen's owner, Charles Dawson, was a former Forever Green sales representative. Ultimately, Forever Green and ProGreen agreed to arbitrate the claims in that action.

Separately, Charles Dawson and his wife Kelli sued Forever Green in Louisiana for unpaid commissions and wages (the "Louisiana Action"). Several years later, the Louisiana court entered a consent judgment in favor of the Dawsons for an amount exceeding $300,000. Forever Green paid nothing to the Dawsons in connection with that consent judgment.

[1] The attorney's fees that a debtor incurs in sustaining the bankruptcy court's dismissal order at the appellate level might also be properly assessed against the petitioning creditor. *See, e.g., In re Rosenberg*, 779 F.3d 1254, 1264-66 (11th Cir. 2015); *but see Higgins v. Vortex Fishing Sys., Inc.*, 379 F.3d 701, 708–09 (9th Cir. 2004). Moreover, a bankruptcy court has the discretion to grant attorney's fees and costs incurred to prosecute bad-faith claims for damages under Section 303(i)(2) of the Bankruptcy Code. *See Rosenberg*, 779 F.3d at 1267.

[2] If there are fewer than 12 qualifying creditors, the involuntary petition may be filed by one or more petitioning creditors. Additionally, the Bankruptcy Code permits other creditors to later join in the involuntary petition before the case is dismissed or relief is ordered.

Shortly after the consent judgment in the Louisiana Action was entered, ProGreen sought to terminate the arbitration in the Pennsylvania Action. The Dawsons also obtained a writ of execution against the arbitrator and his law firm for the money that Forever Green paid as advance deposits of the arbitrator's fees. The arbitrator suspended the arbitration until the fee issue was resolved.

The Involuntary Bankruptcy Petitions

After Forever Green sought a court order reinstating the arbitration in the Pennsylvania Action, Charles Dawson, Kelli Dawson and a third creditor filed an involuntary Chapter 7 petition against Forever Green. Forever Green acknowledged that the requirements of Section 303 of the Bankruptcy Code had been met (*i.e.*, there were three petitioning creditors, their claims were not contingent or subject to bona fide dispute, the amount of the claims were at least $15,325 more than the value of any liens securing the claims, and Forever Green was generally not paying its debts as they became due). Nevertheless, Forever Green sought to dismiss the petition as a bad-faith filing.

The Bankruptcy Court granted Forever Green's request to dismiss the involuntary petition, noting that because bankruptcy courts are courts of equity, petitioning creditors in involuntary cases must come to bankruptcy court for a proper purpose. The Bankruptcy Court determined that Charles Dawson was a bad-faith creditor because he was motivated by two improper purposes: (a) to frustrate Forever Green's efforts to litigate its claim against ProGreen (the proceeds of which would have benefited all creditors of Forever Green) and (b) to collect on his $300,000 debt arising out of the Louisiana Action. In essence, the Bankruptcy Court found that in filing the petition, Mr. Dawson put his own interests above those of other creditors, which was contrary to "the spirit of collective creditor action that should animate an involuntary filing." The District Court affirmed the Bankruptcy Court's decision.

The Third Circuit's Decision

On appeal to the Third Circuit, the Dawsons argued that petitioning creditors' subjective motivations for filing an involuntary petition are irrelevant because Section 303 of the Bankruptcy Code specifies only objective requirements for involuntary petitions (as noted earlier in this article). According to the Dawsons, as long as those objective requirements are met, courts must enter the "order for relief" that substantively commences the bankruptcy proceeding without examining the petitioning creditors' motivations for filing the involuntary petition. Some caselaw supports the Dawsons' position. *See, e.g., In re WLB-RSK Venture*, 2004 WL 3119789 (B.A.P. 9th Cir. Nov. 24, 2004); *In re Knoth*, 168 B.R. 311 (D. S.C. 1994).

The Third Circuit rejected the Dawsons' argument, holding that the requirements of Section 303 are just *minimum* requirements – *i.e.*, if one or more of those requirements are not satisfied, the bankruptcy court must dismiss the involuntary petition. However, according to the Third Circuit, even if all of Section 303's requirements are satisfied, bankruptcy courts could still dismiss the petition because of the bad faith of the petitioning creditors. The Third Circuit found this view to be consistent with the structure of Section 303 of the Bankruptcy Code[3], as well as with the equitable nature of bankruptcy. Other courts have adopted the Third Circuit's view as well. *See, e.g., In re U.S. Optical, Inc.*, 1993 WL 93931 (4th Cir. Apr. 1, 1993); *In re Bock Transp.*, Inc., 327 B.R. 378 (B.A.P. 8th Cir. 2005); *In re Manhattan Indus. Inc.*, 224 B.R. 195 (Bankr. M.D. Fla. 1997). Finally, because involuntary petitions usually lead to serious consequences for debtors, the Third Circuit believed that courts should be wary of creditors who file involuntary petitions for the sake of retribution.

After adjudicating that issue, the Third Circuit then had to decide which test should be used to determine whether a petitioning creditor actually acted in bad faith. Because the Bankruptcy Code does not define "bad faith" in the context of involuntary petitions, courts have applied different standards. Some courts have applied an "improper use" test, which asks whether a petitioning creditor had filed an involuntary petition to obtain a disproportionate advantage for itself, particularly when the petitioning creditor could have pursued its interests in a different forum (such as state court). Other courts have applied an "objective" test, which assesses whether a reasonable person would have done what the petitioning creditors did. Still other courts have applied a "totality of the circumstances" test, which looks to both subjective and objective evidence of bad faith.

The Third Circuit chose to adopt the "totality of the circumstances" test, and listed a number of factors that courts could consider in determining whether a petitioning creditor filed an involuntary petition in bad faith, including:

- Whether the petitioning creditors made a reasonable inquiry into the relevant facts and pertinent law before filing the involuntary petition.
- Whether there was evidence that the debtor made preferential payments to certain creditors, or whether the debtor dissipated its assets.
- Whether the involuntary petition filing was motivated by ill will or a desire to harass the debtor.
- Whether the petitioning creditors used the filing to obtain a disproportionate advantage for themselves, rather than to protect against other creditors doing the same.
- Whether the filing was used as a tactical advantage in pending actions.
- Whether the filing was used as a substitute for customary debt collection procedures.
- Whether the filing had "suspicious timing."

Thus, in future cases within the Third Circuit's jurisdiction, bankruptcy courts will examine the factors listed above (among others) to determine whether a petitioning creditor filed an involuntary petition in bad faith. Courts outside its jurisdiction may follow its lead as well.

[3] Section 303 of the Bankruptcy Code mentions bad faith only in the context of assessing damages *after* an involuntary petition has been dismissed. Thus, the Dawsons argued that bad faith cannot be a reason to dismiss the petition *in the first place*. The Third Circuit rejected this argument, stating that it saw no reason why the Bankruptcy Code would permit the imposition of damages for bad-faith involuntary petitions but not allow the same bad conduct to provide a basis for dismissing the petition in the first place.

At the conclusion of its decision, the Third Circuit acknowledged that there is currently a disagreement among courts on the question of whether a good-faith creditor may subsequently join an involuntary petition that had been filed by one or more bad-faith creditors, and effectively "cure" the petition. The Third Circuit did not decide the merits of this question, however, because the deadline for additional creditors to join the petition against Forever Green had already expired. Notably, the creditors in this particular case might have avoided having the involuntary petition against Forever Green dismissed had they gotten more creditors to participate in the involuntary petition. All they would have needed was three qualifying good-faith creditors.

Conclusion

The decision about whether or not to file an involuntary petition is usually not an easy one for a creditor to make, and it is now a bit harder. In a number of jurisdictions, you will need to assess the risk that your involuntary petition may be dismissed as having been filed in bad faith, even if all of the objective requirements are met.

The *Forever Green* decision provides helpful guidance on the types of questions courts may ask in determining whether the petition was filed in bad faith. Particularly in light of the Third Circuit's prominence in bankruptcy matters, this case should be considered by any creditor who is contemplating filing an involuntary petition.

In addition to the good faith issue, creditors should consider having more than three creditors file an involuntary petition, so that if one petitioning creditor winds up being ineligible (either because of that creditor's bad faith or because its claim is disputed), there would still be at least three qualifying good-faith petitioning creditors.

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RECENT CASES

Foreign Borrower's Rights in Indenture Ruled Sufficient to Meet Second Circuit's Controversial Ch. 15 Eligibility Requirement

In re Berau Capital Resources Pte Ltd., a recent opinion by Bankruptcy Judge Martin Glenn of the U.S. Bankruptcy Court for the Southern District of New York[1], may help mitigate a controversial debtor eligibility requirement in effect for courts within the jurisdiction of the U.S. Court of Appeals for the Second Circuit. In *Drawbridge Special Opportunities Fund LP v. Barnet (In re Barnet)*, 737 F. 3rd 238 (2d Cir. 2013), the court held that to obtain recognition of a foreign proceeding under Chapter 15, the foreign entity must not only satisfy the requirements for recognition but must also qualify as a "debtor" under Bankruptcy Code Section 109(a), i.e., the foreign entity must have "a domicile, a place of business, or property in the United States." *Id*. The *Barnet* decision has been criticized for grafting an eligibility requirement applicable to U.S. debtors onto the separate requirements for recognition of a foreign proceeding under Chapter 15, rather than focusing exclusively on the nature of the foreign proceeding and the foreign representative[2]. To date, no other federal circuit court has addressed the issue of whether Code Section 109(a) is applicable in a Chapter 15 case.

In grappling with the necessity of satisfying the eligibility requirement of Code Section 109(a) when considering a petition for recognition, bankruptcy courts in the Southern District of New York (which are bound to apply the law as established in the Second Circuit) have ruled that the foreign representative has met the debtor eligibility requirement by finding *de minimus* property located in the United States. For example, in *In re Suntech Power Holdings*, 520 B.R. 399 (Bankr. S.D.N.Y. 2014), Bankruptcy Judge Stuart Bernstein held that the foreign entity's establishment of a $500,000 bank account in New York, even when the account was titled in the name of an agent, was sufficient "property in the United States" to meet the debtor eligibility requirement of Code Section 109(a). Indeed, the bankruptcy court's decision following the remand ordered in *Barnet* took a similarly liberal view, holding that a retainer paid to the foreign representative's counsel was sufficient "property in the United States." *See In re Octaviar Admin. Pty Ltd.*, 511 B.R. 361, 372-73 (Bankr. S.D.N.Y. 2014).

In *Berau*, Judge Glenn initially ruled that the attorney retainer held by the foreign representative's New York counsel was a sufficient basis for debtor eligibility. However, he then went on to discuss another basis for the foreign entity's eligibility, holding that the foreign entity's contract rights under an indenture agreement were intangible property rights located in the United States and that they satisfied the eligibility requirement of Code Section 109(a). The Bankruptcy Court noted that the indenture was governed by New York law and that it required a number of acts associated with the indenture to occur solely in New York City (such as authentication, delivery and transfer of notes, maintenance of noteholder registries, note redemption and discharge, covenant defeasance, recovery of cash or securities posted in connection with defeasance, amendments to the indenture, and collateral releases). In finding that the situs of the foreign debtor's intangible property rights was in New York, the Bankruptcy Court looked to New York's General Obligations Law and New York's Civil Practice Laws & Rules, which give effect to choice of law and forum selection clauses under circumstances present in the indenture. According to the *Berau* court, the parties' inclusion of these clauses set New York as the "contract situs," such that the foreign entity can be said to have (intangible) "property in the United States."

The *Berau* decision, as with earlier decisions by other bankruptcy judges in the Southern District of New York, serves to minimize the impact of the Second Circuit's imposition of an eligibility requirement in a Chapter 15 case and potentially establishes the means for divergence from *Barnet's* holding in other jurisdictions. The *Berau* decision should also provide a measure of comfort for foreign borrowers that the New York choice of law and forum selection provisions in their indenture agreements may be sufficient to work around the eligibility requirement, without having to fear accusations of bad faith for suddenly depositing funds into a New York bank account or establishing an attorney retainer account to manufacture eligibility. Finally, it would appear that Judge Glenn's opinion with respect to a foreign entity's rights under an indenture should apply equally in the context of a plenary Chapter 11 case for a non-U.S. debtor as it does in the context of an ancillary Chapter 15 case filed by the foreign representative for a non-U.S. debtor.

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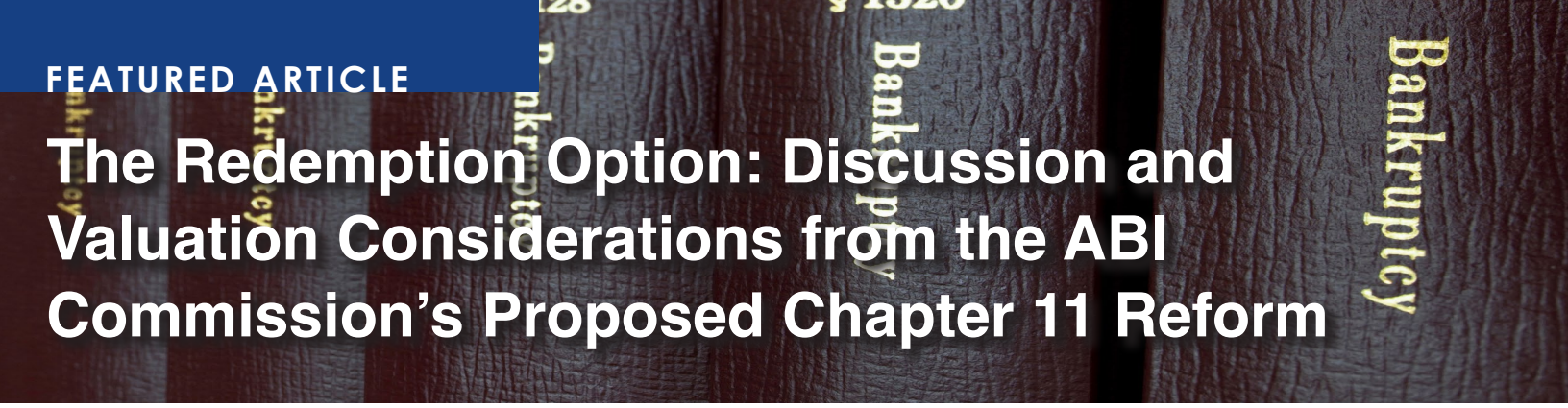
[1] Case No. 15-11804 (Bankr. S.D.N.Y., October 28, 2015).

[2] See generally Daniel M. Glosband and Jay Lawrence Westbrook, "Chapter 15 Recognition in the United States: Is a Debtor 'Presence' Required?", 29 Int'l Insolv. Rev. 28 (2015).



FEATURED ARTICLE

The Redemption Option: Discussion and Valuation Considerations from the ABI Commission's Proposed Chapter 11 Reform

CHRIS FEIGE AND KONSTANTIN A. DANILOV
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The American Bankruptcy Institute (ABI) Commission to Study the Reform of chapter 11 recently undertook a lengthy study to "better balance the goals of effectuating the effective reorganization of business debtors – with the attendant preservation and expansion of jobs – and the maximization and realization of asset values for all creditors and stakeholders." The final report and recommendations, released in late 2014, made numerous proposals regarding different facets of the chapter 11 process. In this article, the focus is on one specific proposal from the ABI Commission's report – the so-called "redemption option." The redemption option is a proposal intended to correct potential unfairness resulting from the valuation of a reorganized company on one particular date during chapter 11 proceedings. Because a reorganized firm's value is often crystallized during a downturn in the economy, senior creditors often get the majority of the equity in the reorganized firm, and therefore capture the firm's future upside, while junior creditors (and existing shareholders) receive nothing. Junior creditors therefore have an incentive to delay the confirmation of the reorganization plan, in hopes that the reorganization value increases, and they can negotiate to receive some value. The redemption option seeks to remedy this by paying junior creditors for the potential future upside they forgo when they accept the reorganization valuation as of a certain date. This potential future value is modeled using an option valuation framework.

The importance of the ABI Commission's recommendation is underscored by the fluid nature of valuation. Both in and out of bankruptcy, the valuation of a company fluctuates over time due to changing expectations of the future cash-flows of the company, and changes in the discount rate used to value the company. The expectation of future cash-flows can change significantly when there are changes within the company, but can also vary in response to changes in the broader market. Likewise, discount rates are impacted by investors' risk appetites and the set of available returns from other investments, both of which are unrelated to the company's performance, but affect the company's valuation. Due to the variability and uncertainty surrounding the expectation of future cash-flows and the discount rate, firm valuations can vary drastically over short periods of time.[1]

If the valuations of large, publicly traded companies in liquid, transparent markets can fluctuate drastically, the valuation of a company in bankruptcy is even more unstable because there is a high level of uncertainty surrounding the future cash-flows of a reorganizing firm. Because most companies enter bankruptcy during an economic downturn, the macroeconomic factors at the time of reorganization often lead to lower expected future cash-flows, and therefore depressed valuations. In many cases, it is likely that a company's valuation will improve with time as broader economic conditions improve.

The successful confirmation of a reorganization plan (or sale) for a chapter 11 debtor depends on the agreement on a single valuation at a single point in time. Valuation uncertainty at the time of the development of the reorganization plan is further compounded by the conflicting incentives of the various creditors negotiating the plan. A lower valuation often benefits senior creditors by undervaluing their claims, allowing them to negotiate control of more equity of the reorganized entity, which in turn allows them to benefit from any future improvements in the company's performance. In contrast, a higher reorganization value allows junior creditors to potentially negotiate for control of more equity, which allows them to benefit from future increases in the value of the reorganized entity.

Junior creditors[2] who expect to receive nothing based on the initial proposed reorganization plan have little or no downside from delaying the reorganization process in hopes that the firm value increases and they can capture some of the equity. Additional time provides the opportunity for either the company's performance or broader economic conditions to improve (or both), and the junior creditors face no downside if the firm's value does not increase, as they are still left with nothing.[3] It is this inherent conflict that the ABI Commission is trying to minimize with the redemption option proposal.

Junior Creditors' Option

In finance parlance, this minimal-downside/high-upside scenario provides junior creditors with an implicit "option." The proposed solution by the ABI Commission is an attempt to formally quantify the value of this implicit option, and to compensate junior creditors so that they are no longer incentivized to delay the confirmation

[1] For example, in the stock market, Price-to-Earnings (P/E) ratios – a measure of how much investors are willing to pay for one dollar of a company's earnings – provide evidence of the significant volatility of valuations over time. The historical average P/E for the S&P 500 is approximately 15, but it has ranged from less than 10 to more than 120 in recent years.

[2] The focus of the ABI Commission Report as it relates to the ROV topic is on the junior creditors. In theory, there could be instances where equity holders could be eligible for the ROV distributions discussed in this article. However, as noted in Footnote 4 below, in these and other cases, additional work would need to be done to determine the exact distribution process. For simplicity, this article focuses on solely the junior creditor example.

[3] The costs of delay by the junior creditors, in the form of additional litigation, are typically borne by the debtor and, by extension, the senior creditors.

of the reorganization plan. More specifically, the proposal would provide the first class of creditors who are "out of the money" (i.e., those representing claims immediately junior to the last security to receive any payment on the claims) with a residual claim amount as part of the reorganization plan. The value of this residual claim would be calculated as the value of a theoretical call option on the reorganized firm's value, intended to replicate the implicit option held by junior creditors. The residual claim amount would be paid to the junior creditors by the senior creditors who receive equity in the firm.[4] These creditors are typically the holders of the last security to receive any payment on claims, known as the "fulcrum" security.

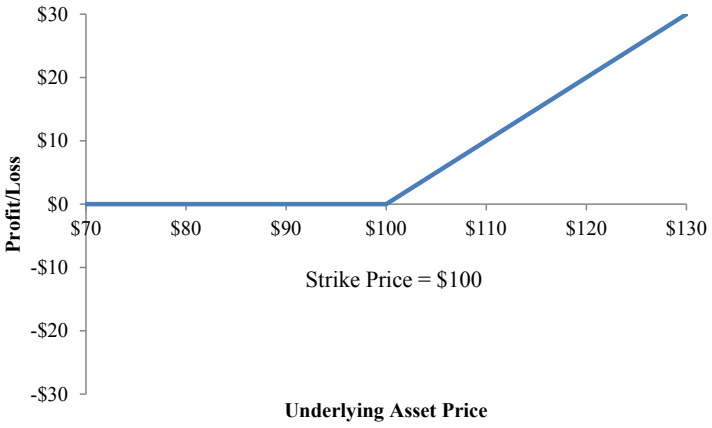
In financial markets, a call option contract gives the buyer of the option the right, but not the obligation, to purchase a stock at a predetermined price (the "strike price") from the seller of the option at a future date (the "expiration date"). Take, for example, an option to buy Apple stock (see Exhibit 1). The buyer of the option purchases the right to buy one share of Apple stock from the seller of the option in one year at a price of $100.[5] At expiration, the buyer of the option will exercise the option if the price of Apple stock is greater than $100. The buyer's profits will be the value of one share of Apple stock less $100. Conversely, if the price of Apple stock is below $100 at expiration, the buyer of the option will not exercise the option, nothing is bought or sold, and the buyer earns zero profit or loss (other than the initial cost of the option).

Because the buyer controls the exercise of the option at expiration, the buyer of the option has only upside, and therefore must pay the seller of the option a "premium" when the option contract is entered. This premium is the value of the option at initiation. A call option's value reflects the range of possible future stock price outcomes, weighted by the probability of each outcome.[6] In the context of the redemption option, a call option provides a mechanism – discussed in detail in the next section – to model and value the possibility that, in the future, the value of the reorganized firm could move in the favor of junior creditors.

Black-Scholes Option Pricing Model

The ABI Commission proposes that the Black-Scholes option pricing model could be used to value the call option and calculate the redemption option claim.[7] The Black-Scholes model is widely used by market participants. It is generally preferred for its simplicity, but market participants recognize that it has some

Exhibit 1: Call Option Payoff



overcome these shortcomings, but they are more complex and require estimates of multiple input values. In many cases, the simplicity of the Black-Scholes model is preferred.

Calculating an option's value under the Black-Scholes model is relatively simple, and requires five main inputs.

Current Price of Underlying Asset: In the Apple example discussed above, this would be the current stock price of Apple. A higher current stock price increases the probability that, at expiration, the stock price will be above the strike price, and therefore increases the option's value.

Strike Price: In the example, this would be the $100 price at which the buyer of the option can buy the Apple stock from the seller. A lower strike price increases the probability that, at expiration, the stock price will be above the strike price, and therefore increases the option's value.

Time to Expiration: In the example, the time to expiration is one year. A longer time to expiration allows more time for the stock price to potentially increase to a price above the strike price, and therefore increases the option's value.

Risk-Free Interest Rate: Conceptually, an option contract replicates ownership of the underlying stock, and this rate represents the cost of borrowing money to buy the stock. In practice, there is no standardized input for the risk-free rate, but it is often estimated using the U.S. Treasury rate.

Expected Volatility of the Underlying Asset: Volatility is the measure of movement in the price of an asset. In the Apple example, the volatility would be the expected volatility of Apple stock over the following year.

It is important to note that expected volatility is the only input that needs to be estimated by the user of the Black-Scholes model; all of the other inputs are known.[9] Higher volatility results in higher option value, because as volatility increases, the likelihood that the stock price increases to a price above the strike price at expiration

[4] The ABI Commission Report notes that in more complex cases, where a single senior class does not receive the entire reorganization value of the firm, or the residual interest (i.e. equity) is spread across multiple classes, additional work will need to be done to sort out the details. The ABI Commission Report simply provides a conceptual framework for the redemption option.

[5] For purposes of this discussion, we focus on European options, which can only be exercised on the expiration date. In contrast, American options can be exercised at any point before expiration date.

[6] To use a simplified example, suppose that the expected price of the stock in one year is $90 in a "low" scenario and $120 in a "high" scenario, and each of these scenarios is equally probable. The expected price of the stock is therefore $105, and as such, a call option with a strike price of $100 is worth at least $5 to the buyer (ignoring present value discounting).

[7] The Black-Scholes option pricing model was developed in the 1970s by Fischer Black, Myron Scholes, and Robert Merton as was one of the first option valuation models. In 1995, Merton and Scholes received the Nobel Prize in Economics for their work, and Black was posthumously recognized for his contributions.

[8] The model is based on several assumptions that are not true in most markets, including: (1) a risk-free interest rate, at which all market participants can both borrow and lend any amount of money, from pennies to millions of dollars; (2) no transactions costs; (3) asset returns that are normally distributed; and (4) no arbitrage opportunities.

[9] The risk-free rate is not actually known, but it can be closely approximated using the U.S. Treasury rate, and has a minimal impact on the output of the Black-Scholes model.

increases. As we discuss below, a small change in the estimated volatility used in the Black-Scholes model can have a large impact on the calculated call option value.

Application of Black-Scholes to Calculate Redemption Option Value ("ROV")

The ABI Commission's suggested calculation method for the redemption option is to apply the Black-Scholes formula.[10] To calculate the value of the implicit option held by junior creditors, the inputs of the Black-Scholes model must be adjusted as provided below.

Current Price of Underlying Asset: This is the expected recovery of the senior classes, including the fulcrum security, at the time of plan confirmation. For example, if the senior classes are expected to recover $8 million of their claims under the reorganization plan, the "current price" is $8 million. This value represents the "reorganization value" of the firm.[11]

Strike Price: This is the full face-value amount of the senior classes, including the fulcrum security (i.e., 100% recovery on senior claims).

Time to Expiration: This is three years from the petition date.[12] Therefore, the time to expiration would be three years, less the time that has elapsed from the petition date to the date on which the option is valued (i.e., the plan confirmation date).

Risk-Free Interest Rate: The ABI recommends that this be based on the U.S. Treasury rate.

Expected Volatility of the Underlying Asset: The ABI recommendation does not specify a particular volatility measure, but states that the volatility input "could vary but can be determined for a particular debtor by looking at the historical volatility of comparable companies, using an agreed upon volatility rate, or using a set metric like the average 60 day forward volatility of the S&P 500 Index for the past four years."

The logic behind setting the inputs as above is to mimic and value the implicit option held by junior creditors. Outside of the redemption option framework, junior creditors would only receive compensation when the fulcrum security holders receive full recovery of their claims (and there is excess value left for the junior creditors' claims). Therefore, the strike price of the redemption option is a 100% recovery of the senior classes including the fulcrum security holders' claims, and the underlying asset price is the current expected recovery on the senior classes including the fulcrum security holders' claims. As discussed, an option's value reflects the range of possible future outcomes, weighted by the probability of each outcome. The redemption option's value results from outcomes where the recovery on the senior classes, including the fulcrum security claim, increases to greater than 100%, and the junior creditors receive value.

As stated in the ABI Commission Report, the redemption option value will be primarily driven by the gap between the current expected recovery on the claims held by the senior classes, including the fulcrum security, and the strike price. If the expected recovery is very low, it is unlikely that the actual recovery could be greater than 100% under any scenario (including highly volatile future company valuations). However, as the gap narrows, the ROV increases and becomes more sensitive to changes in the volatility input.[13]

The negotiated reorganization plan would define the expected recovery to the senior classes, including the fulcrum security, and the strike price of the option. Therefore, the negotiations (or litigation) between the parties involved in valuing the redemption option are likely to focus on the appropriate measure of volatility. The Black-Scholes model requires the "expected" volatility of the underlying asset over the term of the option, but various arguments can be made by opposing parties regarding the appropriate forecasting method of that expected volatility.[14] The ABI Commission suggests using the historical volatility of comparable companies or of the S&P 500 to estimate expected volatility, but reasonable parties could disagree as to which companies form a comparable set and what historical time period to use. We discuss a few potential sources of volatility estimates in the next section, but the key takeaway is that volatility inputs have a large impact on the value produced by the Black-Scholes model, and the estimation of a "reasonable" volatility input is subject to significant debate and a wide range of opinion.

Real-World Example of the Calculation of the ROV

In July 2009, the Lear Corporation, a U.S. auto parts manufacturer, filed for bankruptcy and began the chapter 11 process of reorganization. By November 5, 2009, Lear Corporation submitted its reorganization plan to the courts. Exhibit 2 shows a simplified and stylized version of Lear's reorganization plan,

[10] The ABI Commission recommends, but doesn't require, the use of the Black-Scholes model.

[11] The ABI Commission Report uses an example where the senior class holds the fulcrum security, but in the case where some senior classes are fully repaid in cash and do not receive equity, and a junior class is the fulcrum security, the current price of the asset is the full reorganization value of the firm as a percent of the face value of the senior classes, including the fulcrum security class. The Lear example below provides an example of this scenario.

[12] This is based on research by the ABI Commission, which shows that most bankruptcy-related business issues are resolved within three years following the bankruptcy filing.

[13] As the gap between current price and strike price narrows, higher volatility inputs lead to a higher probability that the reorganization value at expiration will be higher than the strike price. As the outcomes in which junior creditors would receive payments become more likely, the value of the option is higher. Similarly, as the time to expiration increases, there is a longer period for the reorganization value to increase. Therefore, the probability that the reorganization value is higher than the strike price at expiration increases, and the value of the option increases.

[14] Conceptually, there are three main types of volatility estimates. Historical volatility describes the actual realized volatility of the asset over, for instance, over the last 30 days. Historical volatility can be derived by simply observing the price movement of the asset in the market during this period. Expected volatility is the projected price movement in the price over a future period, for instance, the next 30 days. The calculation of expected volatility involves some type of forecasting approach; it cannot be directly observed in the market. Lastly, implied volatility is the volatility that is suggested by the observed market price of an option on the asset. For instance, if the current market price of the option is $5, the volatility input needed to calculate that $5 value using the Black-Scholes formula would be the implied volatility. In practice, the implied volatility is rarely the actual future volatility, but it is the market's expectation of future volatility.

Exhibit 2: Lear Corporation Claims and Expected Recovery Under Chapter 11 Reorganization Plan

($ in millions)	Allowed Claims Under Chapter 11 Reorganization Plan $	Expected Recovery Under Chapter 11 Reorganization Plan $	Expected Recovery %
Class 1A-4A: Senior Group A Claims	2,025	2,025	100%
Class 5A: Junior Unsecured Group A Claims	2,104	884	42%
Subtotal	4,129	2,909	70%
Class 6A-8A: Subordinated Group A Claims	1,000	-	0%
Total	**5,129**	**2,909**	

focusing only on Group A claimants.[15] We assume, for the purposes of this example, that Classes 1A through 4A received 100% recovery under the chapter 11 plan, while Class 5A, the fulcrum security, recovered just 42% of its claim. Combined, the two classes received all of the equity in the reorganized firm.[16]

We use this stylized Lear reorganization plan as an example of how the ROV could be calculated (based on our interpretation of the ABI's proposal) and to show the impact of different volatility assumptions on the option value. The four inputs in Exhibit 3, plus a volatility assumption, are the necessary inputs to value the Lear redemption option using the Black-Scholes model. The strike price ("redemption price") is the $4,219 million allowed claims of the senior classes including the fulcrum security. The current price is the $2,909 million reorganization value of the firm (i.e. the enterprise value)[17]. The time to expiration is three years minus the time elapsed between the chapter 11 filing and the date of the reorganization plan, which for Lear was just over 2.5 years. The risk-free interest rate is the two-year U.S. Treasury rate on the option valuation date. Exhibit 4 illustrates the redemption option value using three reasonable volatility inputs. The ABI Commission suggests the historical S&P 500 volatility as a possible source for the volatility input. Using the historical volatility of the S&P 500 over the three years prior to November 5, 2009, the redemption option value is $234 million. Because Lear is an auto parts manufacturer, one might reasonably argue that the historical volatility of an index of auto parts companies would be a better estimate. Using the three-year historical volatility of the Dow Jones U.S. Auto Parts Index prior to November 5, 2009, the redemption option value is $397 million. Lastly, the VIX is a market index that represents the implied volatility of the S&P 500 over the following 30 days, and is another reasonable estimate of expected volatility in the market. On November 5, 2009, the VIX index reflected an expected volatility of 25.4% which equates to a redemption option value of $163 million. While there is a reasonable basis for using each one of these volatility inputs, the impact of choosing one input versus another, as shown in Exhibit 4, can result in significantly different option values.[18]

As the gap between the current price of the underlying asset and the strike price narrows, the option becomes more valuable and the impact of volatility inputs increases significantly. In the Lear example, the senior and fulcrum security holders' expected return is 70% ($2,909 / $4,129), but if it increased to 90% ($3,700 / $4,129), the redemption option value using the VIX volatility input would increase to $468 million from $163 million – see Exhibit 5. Similarly, the ROV using the historical Dow Jones U.S. Auto Parts Index volatility input would increase from $397 million to $789 million.[19] As the fulcrum security holders' expected return nears full recovery of 100%, the option value and the impact of the volatility input both increase significantly.

Exhibit 3: Black-Scholes Redemption Option Valuation Inputs

Strike Price	4,129
Current Price of the Underlying Asset	2,909
Time to Expiration	2.54
Risk-Free Interest Rate	0.90%

Exhibit 4: ROV Using Different Volatility Inputs

Data Source (as of November 5, 2009)	Volatility	Option Value ($ Millions)
VIX	25.4%	$163
Historical 3-yr S&P 500	29.8%	$234
Historical 3-yr Dow Jones Auto Parts Index	39.1%	$397

Exhibit 5: ROV Using Different Volatility Inputs Assuming Expected Recovery is 90%

Data Source (as of November 5, 2009)	Volatility	Option Value ($ Millions)
VIX	25.4%	$468
Historical 3-yr S&P 500	29.8%	$572
Historical 3-yr Dow Jones Auto Parts Index	39.1%	$789

15 The plan details have been greatly simplified in order to focus on the calculation and magnitude of the residual option value. The Class 6A-8A allowed claim amount, which included equity claims, was arbitrarily set at $1B solely for the purposes of the example. The actual confirmed plan recovery amounts and distribution details differ from the example. See Disclosure Statement for Debtors' First Amended Joint Plan of Reorganization Under chapter 11 of the Bankruptcy Code, In re Lear Corporation, et al.., Ch.11 Case No. 09-14326 (ALG) (Bankr. S.D.N.Y. Sep. 21, 2009), accessed at: http://bankrupt.com/misc/Lear_1stAmDisclosure.pdf

16 How the residual option value would be paid out is a complex discussion, which is beyond the scope of this article. In reality, both senior classes received residual equity interest in the firm, so in theory, both would have to pay out the ROV to the junior creditors. We combine Class 6A-8A into one class, but if Class 6A was senior to class 7A and 8A, the redemption option value would be paid to Class 6A alone. An interesting question is what would happen if the redemption option value was more than the value of Class 6A's claims. Class 7A and 8A may reasonably demand a portion of the redemption option value.

17 On page 222 of the ABI Commission Report, the ABI Commission provides an example of the calculation of the redemption option value. In the example, the strike price ("redemption price") is set to 100% and the current price ("reorganization value") is set to the expected recovery of the senior debt. The price of the residual option is shown as a "percentage of Reorganization Value," calculated using the Black-Scholes model. In contrast, we use the dollar value of the strike price and current price, which produces the dollar value of the option. The ABI Commission method produces a percentage (5.32% in their example) which they state is "approximately 5 percent of the reorganization value." After recalculating the option value using the ABI inputs, we believe that the percent value calculated in this manner would actually be a percentage of the redemption price (i.e. the allowed claims of the senior debt including the fulcrum security) and not the reorganization value. In contrast, in our example, we use the dollar values of the redemption price and reorganization value, which produces a dollar value of the option directly.

18 One point of interest on the volatility input is that the ABI commission report refers to S&P volatility, which represents equity volatility, but the ABI's description of the option valuation uses the current reorganization enterprise value of the firm. The reorganization value of the firm includes the value of both equity and debt. Equity volatility is high, while debt volatility is effectively zero, and enterprise value volatility is somewhere in between. In theory, one could argue that it would be more precise to value the option using an enterprise value volatility measure with the enterprise value of the firm. Alternatively, the valuation of the option could be based on only the equity portion of the reorganization value of the firm, and use an equity volatility input. In the latter case, the redemption price would need to be adjusted proportionately to exclude pre-petition claims converted to reorganized debt.

19 These calculations assume that the total reorganization value changes and highlights the impact on the redemption option value of this change in the expected recovery to the fulcrum security holders.

Conclusion

The ABI Commission's redemption option proposal seeks to correct the potential unfairness arising from arbitrary reorganization plan valuation dates and remove junior creditors' incentive to delay reorganization plan confirmation. The proposal's use of the call option framework to model the value of the implicit option held by junior creditors is a valid approach, but the calculation of the option value is heavily dependent on assumptions about volatility. As shown in the Lear example, the redemption option value may be significant and very sensitive to the volatility input. Because there is no "correct" input for the expected volatility of the reorganized company value, the decision around the volatility input may lead to disputes between senior and junior creditors.[20] The senior creditors will be incentivized to argue for a lower volatility input and the junior creditors will be incentivized to argue for a higher volatility input, and they will both be able to make reasonable arguments to support their claims, leading to debate and potential litigation.

[20] The impact of volatility on the valuation of redemption options has several interesting implications for both senior and junior creditors. In financial markets, volatility is viewed as a measure of risk – the stock prices of high-risk technology companies tend to move more wildly than that of utility companies, for example, and the stock market becomes more volatile during periods of economic uncertainly. The implication of this volatility is that (holding other variables constant) the redemption option value will be higher for riskier firms and for firms that fail during economic downturns. It is difficult to predict what impact, if any, this would have on the behavior of senior and junior creditors towards riskier firms.

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Identifying the 'Identifiable Event' for a Discharge of Indebtedness

By Peter Enyart

A discharge of indebtedness generally results in taxable income equal to the amount realized on the discharge. Thus, a taxpayer who borrowed $100 will be subject to income tax on the balance due if the debt is extinguished without a full repayment. The exceptions and exclusions to this general rule will be briefly discussed in the *Background to Discharge of Indebtedness Income* below, but the focus in this discussion will be on identifying when a discharge of indebtedness occurs for federal income tax purposes.

Understanding the timing element of a discharge of indebtedness income is crucial for effective tax planning. A debt is considered discharged (i.e., cancelled or forgiven), which will result in taxable income, at the moment that the debt will never have to be repaid. An "identifiable event" that fixes the creditor's loss indicates the time when the debt discharge has occurred. However, identifying these identifiable events are often not as straight forward as one may think. For instance, what is the identifiable event for a taxpayer that defaulted on its bank debt during year 2, became insolvent during year 3 and then liquidated in year 4? The answer is determined by the taxpayer's facts and circumstances which will determine the moment that it becomes clear the debt will never have to be repaid.

This article will focus on identifying common identifiable events by looking at some of the existing tax authorities. Also, it will highlight the related taxpayer Form 1099-C reporting obligations.

Background to Discharge of Indebtedness Income

The U.S. Supreme Court has held that federal income tax applies to "all income from whatever source derived," which includes an accretion of income from a discharge of indebtedness.[1] The Internal Revenue Code ("IRC") codified the rule by stating gross income includes income from discharge of indebtedness in Section 61(a)(12).

Fortunately for taxpayers, several exceptions and exclusions limit the taxability of the discharge of indebtedness income. Below is a list of the exceptions and exclusions available to taxpayers:

Debt cancellations or reductions that qualify for EXCEPTION to inclusion in gross income:

1. Amounts specifically excluded from income by law such as gifts, bequests, devises or inheritances;[2]
2. Cancellation of certain qualified student loans;[3]
3. Canceled debt, that if it were paid by a cash basis taxpayer, would be deductible;[4]
4. qualified purchase price reduction given by a seller;[5] and
5. Any Pay-for-Performance Success Payments that reduce the principal balance of your home mortgage under the Home Affordable Modification Program.[6]

Canceled debt that qualifies for EXCLUSION from gross income:

1. Debt canceled in a Title 11 bankruptcy case;
2. Debt canceled during insolvency;
3. Cancellation of qualified farm indebtedness;
4. Cancellation of qualified real property business indebtedness; and
5. Cancellation of qualified principal residence indebtedness.[7]

Qualifying for an exception or exclusion requires an alignment of the exception or exclusion to the tax period in which the identifiable event occurs. Thus, for example, an identifiable event that triggers income from a discharge of indebtedness would be more favorable to the taxpayer if it incurred in a tax period in which the taxpayer was insolvent because of the insolvency exclusion. Therefore, the overlap of these exceptions and exclusions with the identifiable event drives many of the income tax consequences from the discharge of indebtedness

The 'Identifiable Event'

The identifiable event, in effect, is the triggering event that establishes the moment it becomes clear that debt will never have to be paid. It is this point that the debt must be viewed as having been discharged. For this purpose, the Tax Court has described the identifiable event as a practical test of worthlessness of the debt.[8]

The term "identifiable event" was coined by the U.S. Supreme Court to describe the moment in which a loss (i.e., a loss on the debt) has fixed with certainty. Although numerous factors may suggest a debt is worthless (e.g., insolvency, lack of assets, persistent refusals to pay on demand, ill health, death, disappearance, abandonment of business, bankruptcy, and receivership), there are very few, if any, absolute factors that dictate worthlessness. Instead, judgment is needed in assessing the facts and circumstances of the taxpayer. Nevertheless, there needs to be a triggering event that tips the weight of a debt's value from questionable to worthless. This

1 *United States v. Kirby Lumber Co.*, 284 U.S. 1, 52 S. Ct. 4, 76 L. Ed. 131 (1931).
2 IRC Section 102(a).
3 IRC Section 108(f).
4 IRC Section 108(e)(2).
5 IRC Section 108(e)(5).
6 Revenue Ruling 2009-19.
7 IRC Section 108(a)(1).
8 *Brountas v. Commissioner*, 74 TC 1062.

triggering event is the identifiable event that establishes when the debt is deemed discharged for federal income taxes.

Identifying the 'Identifiable Event'

An analysis is needed to determine the moment it is clear that the underlying debt will never have to be repaid.[9] For instance, the abandonment of the security for a nonrecourse debt is such an event that is sufficient to indicate that the debt won't be repaid. Therefore, the creditor's abandonment is a prominent example of an identifiable event resulting in a discharge of indebtedness. However, such an overt act is not required to establish a discharge. Instead, the taxpayer's actions in the circumstances of the case may ultimately be determinative.[10]

Often, there may be multiple events that could be argued as the identifiable event. The Tax Court has stated that "it will often be impossible to find one, and only one, event that clearly establishes the time of abandonment; there is likely to be a range of times, any one of which would be reasonable."[11] More than one identifiable events may not come as a surprise. Consider again the taxpayer that defaulted on its loan in year 2, became insolvent in year 3 and the liquidated in year 4; yet when a taxpayer and the Internal Revenue Service ("IRS") disagree on the indefinable event, the burden is on the taxpayer to prove the event determined by the IRS is unreasonable. In fact, the Tax Court (in memorandum form) held it was not arbitrary for the IRS to conclude that the Taxpayer's debt was discharge based on financial statements the Taxpayer presented to the IRS and that it was the Taxpayer's burden to prove differently.[12]

Insolvency is Not a De Facto Discharge of Indebtedness

The fact that a debtor may be insolvent is a strong factor that may indicate worthless debt, however, insolvency in and of itself is not an identifying event for determining a discharge. Consider *Friedman, ET AL. v. Commissioner*, where a taxpayer's steel service company entered into bankruptcy proceedings as a result continuing losses.[13] At that time, the company was insolvent. Due to the insolvency, the company reported income from the discharge of indebtedness because, in the eyes of the Taxpayer, it was clear that approximately $20 million of indebtedness would never be repaid.

The courts, however, disagreed with the Taxpayer. In affirming the Tax Court, the Sixth Circuit held that some sort of identifying event or forgiveness on the part of the creditors was necessary in order to give rise to a discharge of indebtedness income. Accordingly, the courts held that the evidence supported the notion that steel company did not realize a discharge of indebtedness because no such identifiable event had occurred. Instead, in *Friedman, ET AL*, the bankruptcy court needed to have granted the discharge as part of a plan approved by the bankruptcy court. Merely entering bankruptcy proceedings as an insolvent company was not sufficient to establishing a discharge because insolvency did not create a de facto discharge. Two points were emphasized in this regard. First, a bankruptcy trustee was actively administering the bankruptcy estate for multiple years following the date in which the Taxpayer claimed a discharge occurred. During this time, the trustee continued to file periodic reports with the bankruptcy court about the company's assets, receipts, and disbursements, which presumably indicated a going concern of the company and some expectation of a debt repayment. Second, a claim for fraudulent conveyance between the debtor and its creditors were negotiated over a period of multiple years and settled for nearly $2 million more than originally offered by the Taxpayer, a factor of uncertainty that prevented a fixing of the discharge in the year purported by the Taxpayer.

Thus, merely being insolvent is not an identifiable event that translates into a discharge of indebtedness.

Form 1099-C Reporting Requirements and the Implication of Filing

Lenders (including, but not limited to banks, credit unions, Federal Government agencies, and certain financial institutions) are generally required to file with the IRS a Form 1099-C to report certain identifiable events involving a discharge of debt of $600 or more. A copy of the Form 1099-C is also required to be furnished to the borrower. Failure to comply with the reporting requirements is subject to penalties.

Of importance is the fact that the instructions to Form 1099-C provides nine identifiable events that require reporting on the form. The identifiable events include:

1. A discharge in bankruptcy under Title 11 of the U.S. Code;
2. A cancellation or extinguishment making the debt unenforceable in a receivership, foreclosure, or similar federal nonbankruptcy or state court proceeding;
3. A cancellation or extinguishment when the statute of limitations for collecting the debt expires, or when the statutory period for filing a claim or beginning a deficiency judgment proceeding expires. Expiration of the statute of limitations is an identifiable event only when a debtor's affirmative statute of limitations defense is upheld in a final judgment or decision of a court and the appeal period has expired;
4. A cancellation or extinguishment when the creditor elects foreclosure remedies that by law extinguish or bar the creditor's right to collect the debt. This event applies to a mortgage lender or holder who is barred by local law from pursuing debt collection after a "power of sale" in the mortgage or deed of trust is exercised;
5. A cancellation or extinguishment making the debt unenforceable under a probate or similar proceeding;
6. A discharge of indebtedness under an agreement between the creditor and the debtor to cancel the debt at less than full consideration (for example, short sales);
7. A discharge of indebtedness because of a decision or a defined policy of the creditor to discontinue collection activity and cancel the debt. A creditor's defined policy can be in writing or an established business practice of the creditor. A creditor's established practice to stop collection activity and abandon a debt when a particular nonpayment period expires is a defined policy;
8. The expiration of the nonpayment testing period (commonly referred to as the 36-month rule); and
9. Other actual discharge before an "identifiable event."

What is interesting regarding the filing of Form 1099-C is that a lender may not be able to seek collection of an outstanding debt once a Form 1099-C has been issued to the borrower. That was the case where the U.S. Bankruptcy Court held that "it is inequitable to require a debtor to claim cancellation of debt income as a component of his or her gross income and subsequently pay taxes on it while still allowing the creditor, who has reported to the Internal Revenue Service and the debtor that the indebtedness was cancelled or discharged, to then collect it from the debtor……

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9 *Cozzi v. Commissioner*, 88 TC 435.
10 *Id.*
11 *Id.*
12 *Gerald E. Toberman, et ux. v. Commissioner*, TC Memo 2000-221.
13 85 AFTR 2d 2000-2210 (216 F3d 537)

The court does not agree with the argument that because a Form 1099-C can be corrected or amended, it cannot constitute an admission by a creditor that a debt has, in fact, been discharged or cancelled and that the debtor is no longer indebted thereon."[14] Thus Lenders need to understand the implications of filing Form 1099-C and should be advised to not file it unnecessarily.

For the borrower, like the other Forms 1099 (e.g., 1099-DIV, 1099-INT, 1099-MISC), the IRS will use the provided information to confirm any discharge of indebtedness was reported on the borrower's income tax return. Borrowers need to understand the income tax implications on receipt of a Form 1099 as they generally will be expected to report income tax on the amount reported, unless they can apply an exception or exclusion from gross income.

As a result, both lenders and borrowers need to be aware of these identifiable events as provided by the IRS with respect to Form 1099-C.

Conclusion

The moment it becomes clear that a debt will never have to be paid, such debt must be viewed as having been discharged. These moments are recognized as the "identifiable event" and generally result in taxable income for the borrower. Understanding the timing of these identifiable events is an important aspect of tax planning. Consider the impact of the statute of limitations on tax assessments. Taxpayers frequently argue that the identifiable event occurred in an earlier tax period that is outside the statutes and are therefore no longer liable for the tax. Taxpayers may also argue that the identifiable event occurred in a tax year they were insolvent as to claim the exclusion from gross income (See *Background to Discharge of Indebtedness Income* above for more information on the exceptions and exclusions from gross income). Even if the no exception or exclusion applies, taxpayers may aim to recognize the discharge in a tax period where net operating losses or other tax attributes can shelter their income tax liability. These sorts of planning techniques are only effective, however, if the taxpayer can successfully argue that the identifiable event occurred in the tax period that aligns with their plan.

Ultimately, the identifiable event that will establish discharge of indebtedness income will be driven by the taxpayer's facts and circumstances. As a result, taxpayers need to understand that their facts and circumstances will ultimately trigger or defer the recognition of the income from a discharge of indebtedness.

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[14] William Stanley REED, Debbie Elaine Reed, Debtors., United States Bankruptcy Court, E.D. Tennessee, May 14, 2013.

Disregarded Entities in Chapter 11 Proceedings

By Jonathan Baker

In general, when a taxpayer's obligation to repay a debt obligation is either fully or partially discharged, the taxpayer recognizes income to the extent of the debt relief.[1,2] However, there are a number situations where this discharge of indebtedness income is excluded from a taxpayer's taxable income, including when the taxpayer is subject to Chapter 11 Bankruptcy.[3] But what happens if the entity that in the Chapter 11 Bankruptcy proceeding is a disregarded entity for income tax purposes?

In order to satisfy the requirements to excluded debt discharged as part of a Chapter 11 proceeding, the taxpayer must be "under the jurisdiction of the court in such case and the discharge of indebtedness is granted by the court or is pursuant to a plan approved by the court."[4] It is generally clear when debt is discharged pursuant to the approved plan by the court, though a taxpayer should always take steps to ensure that the plan approved by the court is clear on the amount of debt discharged. The requirement for the taxpayer to be subject to the bankruptcy court's jurisdiction to exclude discharge of indebtedness income stemming from a Chapter 11 Bankruptcy raises some interesting questions when it is a disregarded entity that files for bankruptcy.

Who is the taxpayer?

The statute requires that the taxpayer be subject to the jurisdiction of the bankruptcy court. From a legal perspective, a disregarded entity is distinct from its owner and thus can be subject to a bankruptcy proceeding that its owner is not a party to. However, from a tax perspective the disregarded entity is generally not considered a separate or distinct from its owner (there are some exceptions to this general rule, such as payroll taxes). The IRS has promulgated regulations which clarify that for purposes of the exclusion of cancellation of indebtedness income that the taxpayer is the owner of the disregarded entity, not the disregarded entity itself.[5] The preamble makes it clear that IRS does not feel that a taxpayer's mere ownership of a disregarded entity does not make the taxpayer subject to the jurisdiction of the tax court.

Does the taxpayer need to be the debtor to be subject to the jurisdiction of the tax court?

If the owner of a disregarded entity is not subject to the jurisdiction of the bankruptcy court merely through its ownership of a disregarded entity that has filed a bankruptcy petition, does this mean that the taxpayer must be the debtor in a bankruptcy proceeding to be considered subject to the jurisdiction of the court? The statute is silent on whether to be "subject to the jurisdiction of the court" the taxpayer must be the debtor.

The proposed regulations do not shed further insight onto whether the taxpayer must also be the debtor in the chapter 11 proceeding.[6] The proposed regulations merely reiterate that the owner of a disregarded entity that has indebtedness discharged through Chapter 11 Bankruptcy proceedings may exclude this income if the owner is also subject to the jurisdiction of the court.

The Tax Court has held, to be subject to the jurisdiction of the court, the taxpayer is not required to be the debtor. In *Gracia*,[7] the court held that a general partner of a partnership that went through Chapter 11

[1] Unless otherwise indicated, all "§" references are to the Internal Revenue Code of 1986, as amended (the "Code" or "IRC"), and all "Treas. Reg. §," "Temp. Treas. Reg. §" and "Prop. Treas. Reg. §" references are to the final, temporary and proposed Regulations, respectively, promulgated thereunder (the "Treasury Regulations"), all as in effect as of the date of this memorandum. All "Service" or "IRS" references are to the Internal Revenue Service.

[2] §61(a)(12)

[3] §108(a)(1)(A)

[4] §108(d)(2)

[5] Prop. Treas. Reg. §1.108-9(a)

[6] Prop. Treas. Reg. §1.108-9(a)

[7] Gracia v. Com'r, TC Memo 2004-147

Bankruptcy could exclude the discharge of indebtedness income even though the partner was not the debtor in the Chapter 11 proceeding. The court found that because the bankruptcy court specifically took jurisdiction over the partner with respect to its potential liability for the obligations of the partnership as general partner (and as a guarantor), that the general partner was subject to the jurisdiction of the court. As a result, the partner was able to exclude the discharge of indebtedness income. It should be noted that the IRS has not acquiesced on this case. As a result, there is uncertainty as to whether the IRS will challenge a taxpayer that excludes cancellation of indebtedness income stemming from the Chapter 11 Bankruptcy of its disregarded entity.

Can you avoid this uncertainty by electing to treat the disregarded entity as a corporation?

Given that there is uncertainty as to the ability of a taxpayer to exclude the cancellation of indebtedness income of its bankrupt disregarded entity, is it possible to avoid this issue entirely by electing to treat the disregarded entity as a taxable corporation? This would eliminate the disconnect between the "taxpayer" and the entity that is actually the debtor for legal purposes. There are two problems that make this approach infeasible.

First, from a practical standpoint, there may be adverse consequences to the election to be treated as taxable entity. When a disregarded entity elects to be taxed as a corporation, it is deemed to have contributed all of the assets and liabilities held by the disregarded entity in exchange for stock of that corporation.[8] The rules that generally apply to the formation of a corporation apply to this deemed transfer.[9] In order to qualify as a tax free incorporation under tax law, the transfer must be of property solely in exchange for stock, with the transferors must be in control of the corporation immediately following the transaction, and there must be a valid business purpose for the incorporation.[10]

In the context of a bankruptcy, it may be difficult to meet the control requirement. For purposes of a tax free incorporation, control is defined as 80% of the vote and value of a corporation.[11] It is likely that an election to be taxed as a corporation that is contemporaneous with a bankruptcy proceeding will be considered together with the bankruptcy restructuring as one transaction. As a result, if some of the lenders receive equity in exchange for the cancellation of the debt, this may lead the deemed incorporation not meeting the control requirement, and becoming a taxable transaction.

In addition, when liabilities in excess of the adjusted basis of the assets transferred into a corporation in an otherwise tax free transaction, gain is recognized to the extent the liabilities exceed the adjusted basis of the assets transferred.[12] There is a strong possibility in the context of a bankruptcy that the amount of debt exceeds the adjusted basis of the assets that would be deemed contributed. As a result, gain will be recognized to the extent the liabilities deemed transferred in the incorporation exceed the adjusted basis in the assets contributed.

It is also possible that the bankruptcy cancellation of indebtedness exclusion could be denied if the principal purpose of the incorporation was to avoid federal income tax.[13]

Even if the these practical concerns surrounding electing to be taxed as a corporation do not eliminate making an entity classification election as a practical option, the bankruptcy trustee may be able to block any attempt to make an entity classification election. In general, all of the property of the debtor becomes property of the bankruptcy estate.[14] Congress made it clear that the definition of property in this case was to be interpreted very broadly, and should include anything of value that the debtor has, including intangible property and claims of right.[15] A bankruptcy trustee is empowered by the law to avoid both pre-bankruptcy transfer of property,[16] and post-bankruptcy petition transfer of property.[17] While there is no direct authority on whether a bankruptcy trustee can block an entity classification election, analogous case law seems to indicate that a bankruptcy trustee is so empowered. In the case of a corporation attempting to revoke its election to be taxed as an S Corporation. The courts have held that bankruptcy trustee has the authority to avoid this revocation of S Corporation status, both immediately prior to a bankruptcy petition being filed,[18] or after the bankruptcy petition has been filed.[19] Both these cases concluded that a corporation's S Election status was property of the bankruptcy estate, and thus the bankruptcy trustee had authority to prevent the revocation of the S Corporation Election. Further, courts have also held that the election to forego net operating loss carrybacks is also property, and that the bankruptcy trustee has the authority to prevent the corporation from making such an election.[20] Given that the courts have found two analogous tax elections to be property of the bankruptcy estate subject to the control of the bankruptcy trustee, it does not take a long logical leap to conclude that an entity classification election would also be considered property of the bankruptcy estate, and that a bankruptcy trustee would be able to avoid an election to be taxed as a corporation that is contemporaneous with a bankruptcy petition.

Are there any planning options available to a taxpayer with a disregarded entity entering bankruptcy?

The uncertainty surrounding the ability of owner of a disregarded entity to exclude the income stemming from the discharge of indebtedness in Chapter 11 Bankruptcy and the ability of a bankruptcy trustee to avoid an entity classification election to treat the disregarded entity as a corporation limits a taxpayer's planning opportunities. However, as evidenced by the Gracia line of cases, the courts may be persuaded that to be subject to the jurisdiction of the courts for purposes of the exclusion of discharge of indebtedness income even if the taxpayer is not the debtor in the case of an owner of a disregarded entity. Ultimately, the right course of action will be entirely dependent on the facts and circumstances surrounding both the disregarded entity entering bankruptcy, but also the circumstances of the owner of the disregarded entity. As such, it is imperative for a taxpayer facing bankruptcy of its disregarded entity to engage its legal and tax advisors early in the process to ensure that appropriate consideration is given to the tax challenges of such a situation.

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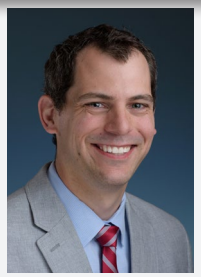

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8 Treas. Reg. §301.7701-3(q)(1)(iv)
9 *Id.*
10 §351(a)
11 368(c)
12 357(c)
13 269(a)
14 11 U.S.C. §541
15 H. Rep't No. 95-595, 95th Cong., 1st Sess. 176 (1977)
16 11 U.S.C. §548(a)
17 11 U.S.C. §362
18 Parker v. Saunders, 82 AFTR 2d 98-6877 (B.A.P. CA-9, 1998)
19 Hanrahan v. Walterman, 97 AFTR 2d 2006-2626 (Bkrptcy. DC Iowa, 2006)
20 In re Russell, 927 F2d 413 (CA-8, 1991), see also In re Feiler, 218 F3d 948 (CA-9, 2000)

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