AIRA Association of Insolvency & Restructuring Advisors

Journal

Vol. 30 No. 1 - 2016

GLOBAL FINANCIAL CONDITIONS WATCH

By Joseph Brusuelas

What's Inside:

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*CIRA Part 1 held on June 6-8 in California is in conjunction with AIRA's 32nd Annual Bankruptcy & Restructuring Conference.

From the **Executive Director's Desk**

THOMAS MORROW, CIRA
AIRA

This is my first letter as Executive Director of AIRA. It is a tremendous honor to be able to take over for Grant Newton who retired at the end of 2015. I knew I was taking on a big role, but as I dig in, I am amazed at how much Grant did for the organization. Please have patience with me as I learn my new job. I am trying to do my best not to let any balls drop.

I am writing this letter fresh from the annual winter meeting of AIRA's Board of Directors. We had two half days to discuss the state of the organization and talk about future strategic plans. I am fortunate to have the support of a wonderful board of talented professionals who put great time and effort into this organization on a pro bono basis.

We have a number of great events coming up which I hope you will be able to attend, including VALCON16 in Las Vegas on March 14 -16, presented by AIRA, ABI and University of Texas.

We are also kicking off the CIRA schedule for 2016 with courses in February and March. CIRA 1 was presented online in four half day web conferences on February 8, 10, 15, and 22. Online courses are a great way to complete certification requirements without having to travel! CIRA Part 3 took place in the conventional, in-person format in New York City on March 2-4. It was an honor to work with the candidates in both these courses. Details for the CIRA program are on the website at www.aira.org. If you are not already a CIRA or CIRA candidate, please give strong consideration to taking this important step to distinguish yourself from other practitioners and improve your professional stature.

Finally, we are deep into planning the 2016 Annual Conference at the Coronado Island Marriott Hotel in San Diego, June 8-11. The panels and sessions are nearly completed, featuring great topics and speakers, and we are putting together several great activities for everyone during breaks from the educational program. Some of those activities include golf at a nearby course, a brewery tour, a sailing excursion, a tour of Petco Park, and our showcase event, dinner at the world famous San Diego Zoo. Please save the date in your calendar and plan to join us.

A Letter from **AIRA's President**

ANGELA SHORTALL, CIRA
Protiviti, Inc.

I have officially concluded my first month as AIRA's president as I write this. I have served on the AIRA Board of Directors for six years and have been consistently impressed with the devotion of each of the Officers and Directors with whom I have had the privilege to serve. I am now honored to follow Tom Morrow in the role of President as he takes over the role of Executive Director. It is quite a time of change within AIRA. Throughout this period, both Tom and I are committed to maintaining the excellence of this organization and insuring that it continues to provide our members with educational resources that are topical, timely, and cost-effective, and that operate to support our members and the insolvency community as a whole.

As Tom mentions, we are well into the planning for the 2016 Annual Conference. Thanks to an outstanding planning committee, we have a wonderful slate of educational programs lined up; San Diego also provides some outstanding extra-curricular opportunities for attendees and their guests.

The active participation of our members is crucial to our success. We are committed to your professional development by providing the highest caliber educational programs along with opportunities to speak and publish. If you wish to participate in the development and presentation of a webinar, please contact Ed Ordway (eordway@thinkbrg.com). If you would like to publish in the AIRA Journal, or have a concept for an article, please contact Michael Lastowski (mlastowski@duanemorris.com).

I look forward to serving you over the next year and a half. Hope to see you in San Diego!

Global Financial Conditions Watch

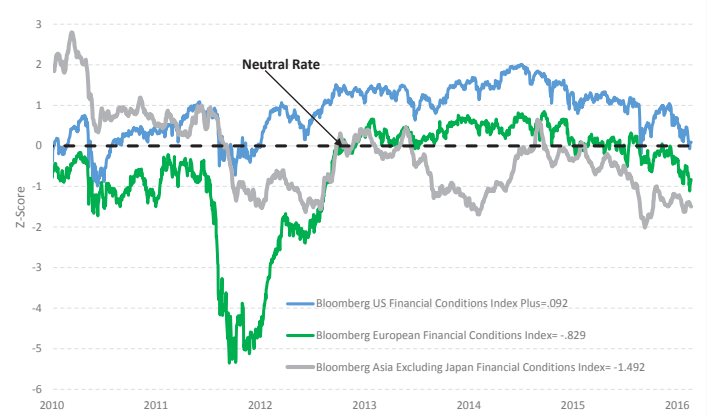
BY JOSEPH BRUSUELAS
Chief Economist, RSM US LLP

Volatility has roiled global financial markets during the past several months driven mostly by growth, debt and financial stability concerns in China and the Eurozone. However, a look at key global measures of credit risk, funding stress and counterparty risk shows financial conditions remain stable. While volatility may continue as global investors rebalance portfolios away from China, European financials, oil, energy and commodities, there is no indication of a general systemic crisis in the near term.

Global Financial Conditions

After China devalued its currency on August 11, 2015, a tidal wave of volatility swept across global asset markets resulting in a general tightening of financial conditions. In Asia, excluding Japan, financial conditions stand at approximately 1.49 standard deviations below neutral, while in Europe they are eight-tenths of one standard deviation below neutral, all of which suggests a net drag on global growth. The Bloomberg Financial Conditions Index Plus stands one-tenth of one standard deviation above neutral.

Global financial conditions tightening

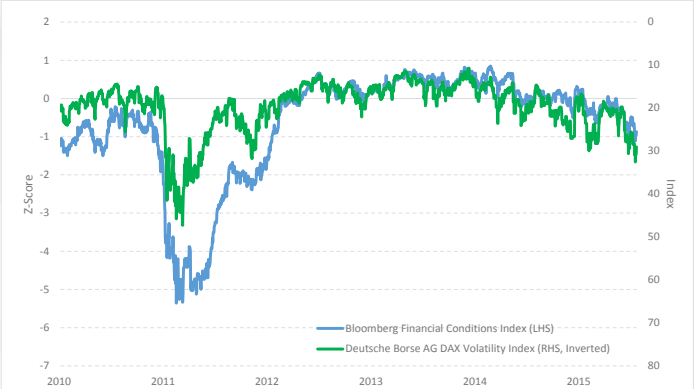


Source: RSM US, Bloomberg

European Financial Conditions

Financial conditions in Europe have tightened noticeably during the past few months, while the Deutsche Bourse AG DAX Volatility index implies further fallout from the slowdown in global growth and renewed European banking stress. Although the European Central Bank's asset purchase program has succeeded in reducing borrowing costs, the gap between regional borrowing costs and overall economic slack implies that the monetary authority will likely increase its quantitative easing program in 2016 and lift the current target of purchases well above the current three trillion euros.

European financial conditions tightening

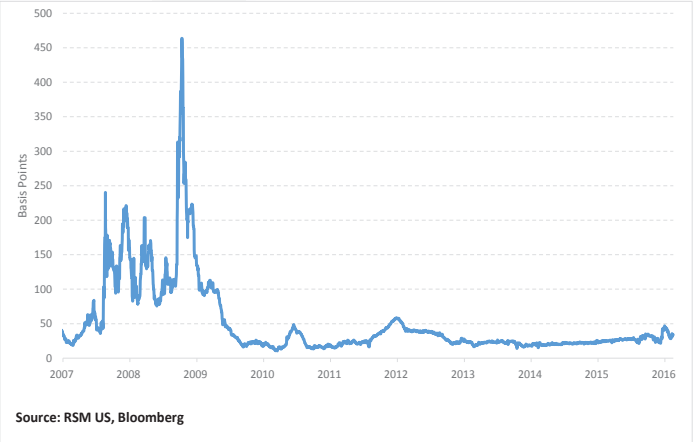


Source: RSM US, Bloomberg

TED Spread

The TED spread, which is the difference between interest rates on interbank loans and short term government debt, is a useful metric for measuring funding stress in global markets. Currently, this spread shows no meaningful increase in credit risk or counterparty risk in the global economy despite another round of concerns over the balance sheets among systemically important banks. During the financial crisis that followed the collapse of Lehman Brothers, both counterparty risk and credit risk increased significantly causing lending to come nearly to a standstill in the United States. The current spread is at 33 compared with 463 at the height of the financial crisis in October 2008.

No sign of funding stress



Source: RSM US, Bloomberg

Two-Year Swap Spread

The spread between the rate on two-year interest rate swaps and U.S. Treasury yields, a measure of credit risk in the global economy, has narrowed to 5.75 basis points from 24.78 on the day when the Chinese devalued the yuan. Swap spreads tend to be useful benchmarks for investors for debt purchases including mortgage-backed securities and auto loans. Narrowing swap spreads mean borrowing costs are falling even as yields on U.S. government securities remain essentially unchanged.

Borrowing costs declining even as government yields are unchanged

Source: RSM US, Bloomberg

Credit Default Swaps on European Banks

Growing concerns about the Eurozone banks' ability to cover contingent convertible bonds, which could require another round of recapitalization to avoid investor losses, have caused credit default swaps on select European banks to noticeably widen back to levels not seen since 2012 at the height of the European sovereign debt crisis. There is clearly trouble brewing in the corporate and financial debt in Europe, which will require a much more vigorous response by the ECB to address this growing problem.

Credit default swaps rising on EU banks

Source: RMS US, Bloomberg

U.S. Dollar/Chinese Yuan and 12-Month Non-Deliverable Forward

Chinese fiscal and monetary authorities have spent close to $1 trillion to prop up equity markets and shore up their currency. The People's Bank of China has been purchasing yuan and selling U.S. dollars to prevent a more rapid pace of devaluation. A look at the 12-month non-deliverable forward (NDF), a measure of Chinese yuan valuation versus the U.S. dollar, implies a further 3.5 percent depreciation in the Chinese currency. The late 2015 25 basis point cut in the policy rate and the 50 basis point reduction in the reserve ratio imply that monetary authorities are increasingly worried about conditions in the real economy. Given these moves, and the strong probability of further fiscal stimulus later this year, it would not be surprising if the NDF market is understating the coming depreciation of the yuan.

NDF may be understating coming yuan depreciation

Source: RSM US, Bloomberg

U.S. Ten-Year Bloomberg Global Bond Market Index

Over the past several months, there has been a widening between the global 10-year benchmark and the Bloomberg Global Bond Market Index, which likely has more to do with the ongoing sovereign debt crisis in the Eurozone, the beginning of the Chinese debt and deleveraging cycle, as well as slowing growth in China. That said, the spread has narrowed since late summer as fears of an imminent Grexit (Greek exit from the Eurozone) have abated even given the recent turmoil in global asset markets.

Imminent 'Grexit' fears have abated

Source: RSM US, Bloomberg

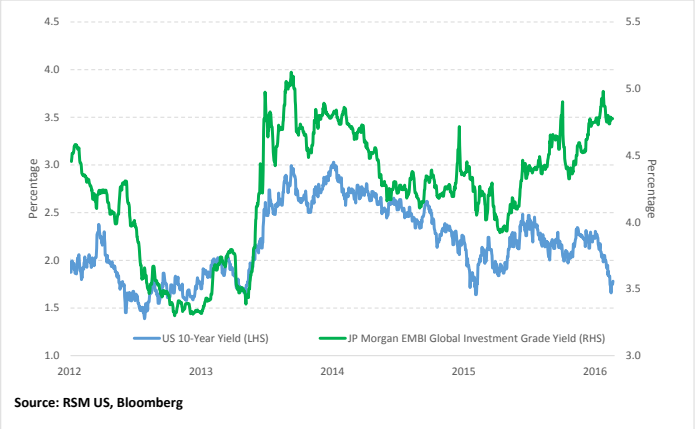
U.S. Ten-Year JP Morgan EMBI Investment Grade Yield

One sign of stress is the U.S. 10-year Treasury versus the JP Morgan EMBI (Emerging Market Bond Index) investment grade yield. There has been a divergence in the two metrics, although the JP Morgan investment grade yield remains

Continued from p.7

about 50 basis points from where it was at the peak of the U.S. so-called "Taper tantrum" when investors panicked over the possibility the Fed would start reducing their asset purchases early. The likely driver of the divergence has more to do with tightening financial conditions associated with the slowdown in Chinese demand for commodities and the knock-on effects in emerging market investment grade debt. This is likely an indication of a modest increase in capital outflows from developing economies.

Increasing capital flows to U.S. from developing economies

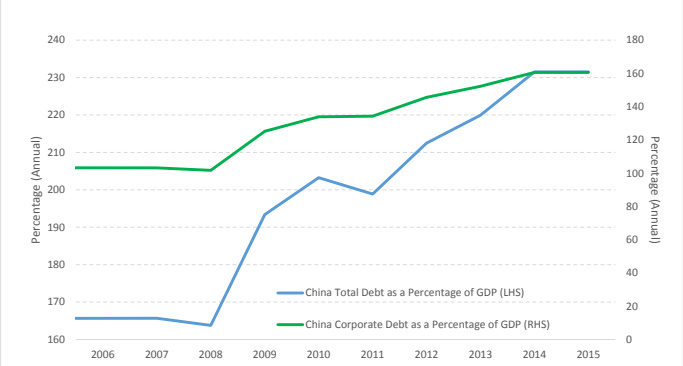


Source: RSM US, Bloomberg

Chinese Debt and Deleveraging Cycle Has Begun

Much of the volatility in global financial markets since late summer 2015 has been driven by investor concerns over the path of Chinese growth, the condition of the Chinese financial system and the total debt of the state and its corporate sector. Since the onset of the U.S. financial crisis in 2006 total Chinese debt has more than doubled, increasing to 231 percent of GDP from 160 percent of GDP at the end of 2014. Once the data is published that number will likely show an increase to well above 300 percent through the end of 2015. Equally troubling is the increase in Chinese corporate debt, which stood at 160 percent of GDP at the end of 2014. With the household debt-to-service ratio standing at well above 33 percent through the end of September 2015, there is justified concern that with the yuan and domestic equity markets under pressure the capacity of Chinese fiscal authorities to respond forcefully to address growth and debt and offset the coming deleveraging is limited at best.

Total Chinese debt-to-GDP has doubled during past decade



Source: RSM US, Bloomberg

ABOUT THE AUTHOR

Joseph Brusuelas

Mr. Brusuelas has over 20 years of experience in finance and economics and specializes in analyzing U.S. monetary policy, labor markets, fiscal policy, economic indicators and the condition of the U.S. consumer. Prior to joining RSM in July 2014, Brusuelas spent four years as a senior economist at Bloomberg, LP. As co-founder of the award-winning Bloomberg Economics Brief, Brusuelas was named one of 26 economists to follow by the Huffington Post. Earlier in his career, he was a director at Moody's Analytics where he covered the U.S. and global economies for the Dismal Scientist website. He also served as chief economist at Merk Investments L.L.C. and chief U.S. economist at IDEAglobal.

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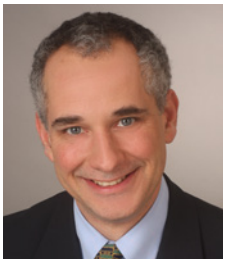

CHICAGO, Feb. 24, 2016 – MorrisAnderson, a financial and turnaround management consulting firm, is pleased to announce the promotion of Steven F. Agran, CIRA, to principal and shareholder. He oversees MorrisAnderson's Northeast/Mid-Atlantic practice and is based in New York City. Agran formerly served as a managing director. In his eight years at MorrisAnderson, Agran has led restructuring, turnaround and interim management projects for financially distressed companies across food services, trucking, distribution, manufacturing, consumer products and retail.

Ninth Circuit's Decision in *Transwest*, and the Erosion of the Doctrine of Equitable Mootness

BY MICHAEL LASTOWSKI
Duane Morris LLP

In *JMPCC 2007-C1 Grasslawn Lodging, LLC v. Transwest Resort Properties, Inc. (In re Transwest Resort Properties, Inc.)("Transwest")*,[1] the United States Court of Appeals for the 9th Circuit refused to dismiss an appeal from the entry of a confirmation order on the grounds of equitable mootness, despite the fact that the appeal requested relief which would materially prejudice the rights of a third party which had invested in the reorganized debtor pursuant to the plan. The opinion appears to minimize the weight to be given to the expectations of parties who finance a debtor's reorganization, and may discourage investors from financing a debtor's chapter 11 exit.

Doctrine of Equitable Mootness

Confirmed chapter 11 plans often embody complex business transactions under which third parties invest in a reorganized debtor. Plans will often reflect a settlement among competing constituencies relating to the payment and priority of claims. Post confirmation, a reorganized debtor may engage in multiple business transactions involving the sale of assets to third parties.

> ***"The opinion appears to minimize the weight to be given to the expectations of parties who finance a debtor's reorganization, and may discourage investors from financing a debtor's chapter 11 exit."***

The expectations of third parties who have relied upon the finality of a plan confirmation order have fortunately been preserved under the doctrine of equitable mootness, a "doctrine by which an appellate court deems it prudent for practical reasons to forbear deciding an appeal when to grant the relief requested will undermine the finality and reliability of consummated plans of reorganization."[2] With the exception of the Federal Circuit (which does not hear bankruptcy appeals), all of the federal circuits recognize this doctrine.[3]

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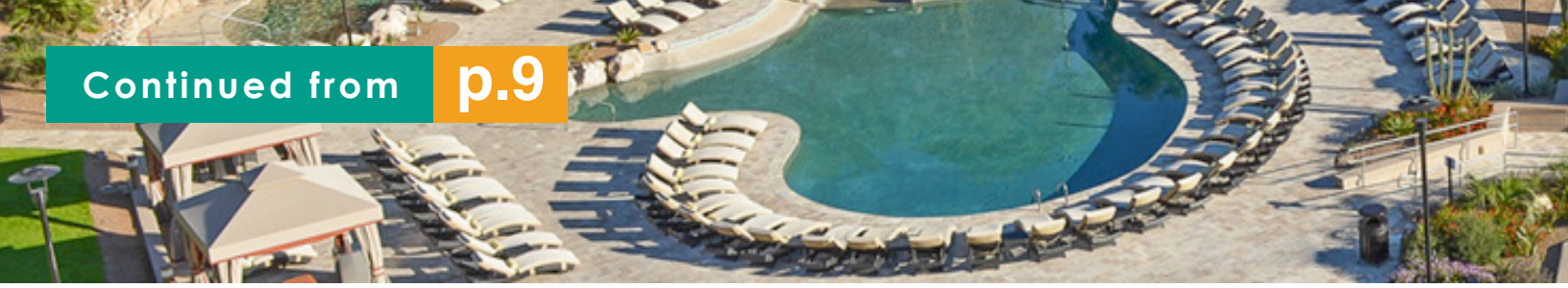
1 801 F.3d 1161 (9th Cir. 2015).

2 *In re Tribune Media Co.*, 799 F.3d 272, 277 (9th Cir. 2015)("*Tribune*").

3 *Id.* at 286 (quoting Nil Ghosh, *Plan Accordingly: The Third Circuit Delivers a Knockout Punch with Equitable Mootness*, 23 Norton J. Bankr. L. & Prac. 224 & n. 8 (2014).

Continued from p.9



Transwest's Chapter 11 Proceeding

In *Transwest*, the debtors owned two hotels. At the time of the chapter 11 filing, the debtors owed one mortgage lender $209 million; they also owed $92 million to a mezzanine lender. At the time of confirmation, the value of the two hotels was $92 million and the mezzanine lender's secured claim was worthless. By the time of confirmation, the mortgage lender (the "Lender") held both its original mortgage loan and the mezzanine loan. The bankruptcy court determined that the total amount of the mortgage lender's allowed claim was $247 million.[4] The lender made an election, pursuant to 11 U.S.C. § 1111(b), to have its entire allowed claim of $247 million treated as secured.[5]

Under the plan, a third party, Southwest Value Partners Fund XV, LP ("SWVP") agreed to invest at least $30 million in the reorganized debtors and would become the sole owner of the debtors. The plan proposed to restructure the mortgage loan so that interest only payments would be made monthly and a balloon payment would be due in 21 years. The restructured loan also included a "due on sale" clause under which a sale or refinance would make the remaining principal under the loan immediately due. Importantly, there was an exception to the due on sale clause between years five and fifteen of the loan. Consistent with 11 U.S.C. § 1129(b)(2)(A)(i)(I) and (II), the lender would receive total cash payment equal to the amount of its allowed claim ($247 million with a present value equal to the value of its collateral ($92 million)) and would retain its liens on the hotels.

The plan was confirmed over the Lender's objection under the "cram down" provisions of section 1129(b).

Before the bankruptcy court and in an appeal before the district court, the Lender argued that the plan's exception from the "due on sale clause" violated 11 U.S.C. § 1111(b)(2)(A). Congress enacted section 1111(b) to avoid a situation where, after confirmation, a lender's collateral dramatically increases in value, and the debtor alone benefits from this increase in value (or, conversely, from an undervaluation of the collateral at confirmation). The lender argued that the due on sale exception undermined Congressional intent.

The Lender also argued that the bankruptcy court erred in finding that the plan satisfied the cramdown requirement that the plan be accepted by at least one impaired class.[6] Specifically, the Lender argued that section 1129 (a)(1) requires that there be an impaired accepting class for each debtor. Here, there was an impaired accepting class for one debtor, but not the other debtor (against which the Lender held its claim under the mezzanine loan).

[4] The bankruptcy court disallowed certain "premiums" which the Lender had added to the loan balance.

[5] Absent the election, the Lender's claim would have been bifurcated into a secured claim of $92 million and unsecured claim for the remainder of its allowed claim ($55 million).

[6] *See* 11 U.S.C. § 1129(a)(10).

The Ninth Circuit's Decision

The Lender appealed the entry of the confirmation order to the district court, which denied the appeal as equitably moot. The Lender then appealed this decision to the United States Court of Appeals for the Ninth Circuit. The Court of Appeals reversed the district court's finding of equitable mootness.

In the 9th Circuit, courts examine four criteria in determining whether there is equitable mootness:

(1) whether a stay of the confirmation order has been sought and obtained;

(2) whether the plan has been substantially consummated;

(3) whether the relief sought will unfairly prejudice third parties; and

(4) whether the bankruptcy court "can fashion effective and equitable relief without completely knocking the props out from under the plan."[7]

The Lender had unsuccessfully sought a stay before the bankruptcy court and the district court. While the failure to seek and obtain a stay of a confirmation order is usually fatal to a bankruptcy appeal in the 9th Circuit, the *Transwest* court held that this factor did not weigh in favor of equitable mootness. The court did not address the Lender's failure to seek a stay before the court of appeals.

"In other words, because SWVP had participated in the plan drafting process as a potential investor in a reorganized debtor, it was not entitled to the protections of equitable mootness."

The parties did not dispute that the plan was substantially consummated.

With regard to the last two criteria, the court appeared to minimize the prejudice to SWVP that would arise in the context of a reversal of the confirmation order and the problems that would arise in fashioning relief for the Lender.

While the criteria for applying the doctrine of equitable mootness vary slightly among the circuits, the impact of the reversal of a confirmation order on third parties is always a consideration in all circuits.[8] In *Transwest*, however, the court emphasized that "the specific relief sought must bear unduly on innocent third parties.[9]

The court's criteria for establishing innocence are likely to chill the enthusiasm of would-be investors in reorganized debtors. Specifically, the Transwest court held that because SWVP:

[7] *Motor Vehicle Cas. Co. v. Thorpe Insulation Co. (In re Thorpe Insulation Co.)*, 677 F.3d 869, 881 (9th Cir. 2012) ("Thorpe").

[8] *See e.g., In re SemCrude, L.P.*, 728 F.3d 314, 321 (3d Cir. 2013) (a court must determine whether granting the relief requested in the appeal will "fatally scramble the plan" and/or "significantly harm third parties who have justifiably relied on plan confirmation"); *Thorpe*, 677 F.3d at 869 (the court must determine "whether it is possible to [alter the plan] in a way that does not affect third party interests to such an extent that the change is inequitable").

[9] *Transwest*, 801 F.3d at 1169 (quoting *Thorpe*, 677 F.3d at 822) (emphasis added).

(1) became involved in the case as a potential new investor and owner pre-confirmation;

(2) participated in confirmation related hearings;

(3) filed pleadings in support of confirmation; and

(4) entered into negotiations relating to the language of the plan and the confirmation order,

it "means [SWVP] is not an innocent third party."[10]

The court further noted that, [i]ndeed, when a sophisticated investor such as SWVP helps craft a reorganization plan that "press[es] the limits" of the bankruptcy laws, appellate consequences are a foreseeable result.[11] In other words, because SWVP had participated in the plan drafting process as a potential investor in a reorganized debtor, it was not entitled to the protections of equitable mootness.

As to the possibility of granting to the Lender appellate relief that would not "knock the props out from under the plan,"[12] the *Transwest* court speculated on possible remedies. With regard to the exception to the "due on sale" provision, the court suggested that if (1) the exception could be narrowed by one day; or (2) the Lender could be awarded a monetary remedy in the event of the exercise of the clause, neither remedy would "undermine the entire plan."[13] With regard to the Lender's objection under 11 U.S.C. § 1129(a)(10), the court noted that the Lender was the only creditor of the debtor for which there was no impaired excepting class and stated that if the Lender were awarded one dollar for its claim, that remedy would not render the plan undone.[14]

The court did not review these remedies to determine whether they would legally satisfy the Lender's plan objections. There is no discussion as to whether these remedies would otherwise satisfy the Lender's objection. The court's treatment of potential remedies suggests that there will never be an instance where the 9th Circuit will determine that a court cannot not fashion equitable relief arising from a successful appeal of a confirmation order and that the doctrine of equitable mootness will never bar an appeal.

Ramifications of the Transwest Decision

The dissent in *Transwest*, recognized the potential harm of the majority's position, explaining:

> This case illustrates perfectly why encouraging reliance on bankruptcy confirmation orders is critical to facilitating complex reorganizations. Once a third party like SWVP invests to improve the debtors' capital, to the benefit of creditors and debtors alike, it is much more difficult for it to walk away if the terms of its bargain are altered on appeal. The rule the majority endorses ignores the realities of the marketplace, and creates strong incentives for investors to delay funding improvements until after the appeal is completed, which may take years.[15]

Indeed, in cases pending in the 9th Circuit, a third party which invests in a chapter 11 debtor pursuant to a plan of reorganization will have to factor into its investment decisions the possibility that, years after confirmation (and after increased and continued investment in the reorganized debtor), its investment may be rendered void as a result of a successful appeal from confirmation.[16] The entry of a final, non-appealable order, which is no longer subject to challenge, may take years.

[10] *Transwest* at 1170.

[11] *Id.* (quoting *Bank of N.Y. Trust Co. v. Official Unsecured Creditors' Comm. (In re Pac. Lumber Co.)*, 584 F.3d 229, 244 (5th Cir. 2009)).

[12] *Thorpe*, 677 F.3d at 881.

[13] *Transwest* 801 F.2d at 1171.

[14] *Id.* at 1172.

[15] *Transwest*, 801 F.3d at 1174 to 1175.

[16] Notably, in *Tribune*, the United States Court of Appeals for the Third Circuit recognized that investors have interests more worthy of protection because "we want to encourage behavior (like investment in a reorganized entity) that contributes to a successful reorganization." *Tribune*, 793 F.3d at 279.

ABOUT THE AUTHOR

Michael Lastowski

Mr. Lastowski is the managing partner of the Delaware office of Duane Morris LLP. He concentrates his practice in bankruptcy and workouts, representing debtors and creditors'committees. Mr. Lastowski is admitted to the bars of Delaware, New York and Pennsylvania. Since 2010, he has been listed annually in Chambers USA: America's Leading Lawyers for Business. He regularly speaks on topics relating to complex chapter 11 cases and has been an instructor at the ABI's annual conference on bankruptcy litigation. He is a member of the board of directors of the Association of Insolvency and Restructuring Advisors and a member of the board of directors of the American Board of Certification, which certifies specialists in business bankruptcies. Mr. Lastowski is a 1980 graduate of the University of Pennsylvania Law School and a 1976 graduate of Brown University.

New CDBVs

Congratulations to the following members who recently earned the designation Certification in Distressed Business Valuation!

J.P. ELDRED
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JP Eldred is an Associate Director in the Richmond office of Protiviti Inc. JP has provided management, restructuring and litigation consulting services to clients in a variety of business challenges for nearly 20 years. His clients have included financial institutions and securities firms, private and public companies, Chapter 11 and 7 debtors and their counsel, Trustees, and governmental agencies. JP specializes in forensic investigation in bankruptcy and litigation matters. JP is a also a CIRA and CFE.

NEIL GUPTA
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Neil Gupta is a Vice President at SSG Capital Advisors where he works with investment banking clients on a wide range of transactions, including mergers and acquisitions, divestitures, recapitalizations and private placements of both senior and subordinated debt and equity. Past client engagements include publicly traded, privately held, private equity sponsored and family owned businesses across a broad range of industries. Neil is a CFA Charter holder and has a BS from Johns Hopkins University and an MBA from the University of North Carolina.

New CIRAs

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

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Abhi Gupta is a Director at Conway MacKenzie where he specializes in providing financial and management consulting services to performing and under-performing companies. He has experience working with public and private companies across varying situations and stages. He focuses on providing financial advisory services including serving in interim management roles to companies in the food and beverage, construction, automotive, telecommunication and manufacturing industries. Abhi holds an MBA (finance and law) from NYU Stern School of Business and is also a Chartered Accountant (India).

K. LUKE HOUSTON
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K. Luke Houston is a Manager with Rocky Mountain Advisory in Salt Lake City, Utah. Mr. Houston has more than seven years of public accounting experience in which he has provided audit, tax, and forensic services. This experience includes business valuations, fraud investigations, damage calculations, bankruptcy consulting, and other litigation services. Mr. Houston is a Certified Public Accountant, Accredited in Business Valuation, Certified in Financial Forensics, and a Certified Fraud Examiner. He holds a Master's of Accountancy from Southern Utah University.

TAMARA JONES-RAMOS
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Tamara is the Founder/Managing Director of T. Jones Financial Services and has more than 16 years of experience in accounting and corporate restructuring for an array of business industries. She specializes in serving as a pre- or post- confirmation Chapter 11 Trustee providing interim management, financial analysis, asset liquidation, turnaround advisory and reorganization services for private and public organizations. Tamara has a BS in Business Finance and MBA in Global Business Management from the University of Phoenix.

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Piotr Luc is a Director at Alderney Advisors where he assists clients in distressed situations and M&A activities. His experience in crisis management, financial and operational restructurings, bankruptcy administration, capital raises, valuations, and financial analysis has led to many successful outcomes. Piotr has an extensive background in automotive and healthcare sectors. He has also represented clients from a range of other industries, including financial services, banking, aviation, shipping, and chemicals. Piotr earned a BBA degree in Economics from Baruch College. He is also a CFA charterholder.

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How AIG Bailout Litigation Resulted in Liability with Zero Recovery[1]

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On June 15, 2015, the U.S. Court of Federal Claims filed its decision in the case of Starr International v. U.S., 121 Fed. Cl. 428 (Fed. Cl. 2015), finding that, although the Credit Agreement Shareholder Class prevailed on claims of liability due to the Government's illegal action, damage recovery was determined to be zero, and that the Reverse Stock Split Shareholder Class did not prevail on either liability or damages. This article takes a detailed look at events and actions by AIG management and key parties in interest, during the weeks and days leading up to the government's controversial takeover of AIG.

In September 2008, the financial crisis that began in August 2007 had developed into the worst experienced by the American economy since the Great Depression of the 1930s, a crisis so broad that it threatened the financial viability of virtually every financial institution. Against this backdrop, the weekend of September 13, 2008 found U.S. Government officials from the Federal Reserve Board, the Federal Reserve Bank of New York (FRBNY) and the U.S. Treasury Department focused on the imminent collapse of American International Group (AIG) – the global insurance conglomerate whose Financial Products Division was economically linked with a majority of other global financial institutions, including ABN AMRO, Banco Santander, Bank of America, Barclays, BNP, Calyon, Citigroup, Credit Suisse, Danske Bank, Deutsche Bank, Goldman Sachs, HSBC, ING, JP Morgan, Merrill Lynch, Morgan Stanley, Rabobank, Societe Generale and UBS.[2]

Finding that, absent an immediate and enormous injection of cash, AIG faced bankruptcy by September 16 (shortly after "Lehman Weekend" and the bankruptcy filing of Lehman Brothers), that its failure would have catastrophic consequences globally, and having explored private sector alternatives to no avail, the Federal Reserve Board of Governors approved an $85 billion loan to AIG, but with unprecedented and punitive terms. These included a rate of interest significantly greater than that given to other troubled financial institutions, an equity ownership interest of 79.9 percent to be retained even after AIG repaid the loan, and the forced resignation of AIG's CEO, in addition to various commitment and undrawn balance fees.[3] The terms were non-negotiable and, having no choice other than bankruptcy, AIG's Board approved the Government's terms, the effect of which was to cede control of AIG to the Government absent any vote by AIG's common shareholders.

On November 21, 2011, Starr International Company, Inc., ("Starr"), at one time one of the largest shareholders of AIG, filed suit against the United States challenging the rescue and takeover. Controlled by Maurice R. Greenberg, CEO of AIG until 2005, Starr alleged that the Government's takeover was in substance a taking without just compensation and an illegal exaction, both of which violated the Fifth Amendment of the U.S. Constitution. Consequently, Starr sought damages exceeding $40 billion.[4]

Consistent with Starr's allegations, the Court certified two classes of shareholders. The first class included the shareholders that owned common stock during the period between September 16 and September 22, 2008 when the Government acquired a 79.9 percent interest in AIG in exchange for providing an $85 billion loan. The second class consisted of the shareholders that owned AIG common stock on June 30, 2009 when the government-controlled board devised a twenty-for-one reverse stock split which reduced the number of AIG's shares outstanding while leaving the number of shares authorized unchanged.[5]

The Court identified two key issues in the litigation. The first was whether the FRBNY had legal authority to acquire the equity of a borrower when extending a loan. The second was given that AIG's Board had voted to accept the Government's terms on September 16, 2008, could the Government's taking of AIG's equity absent the payment of just compensation be legal under the Fifth Amendment.[6]

1 *Starr Int'l Co. v. United States*, 121 Fed. Cl. 428 (Fed. Cl. 2015). The detailed background provided in this decision served as a primary source of information for this article regarding many specific events and actions pertaining to the AIG bailout.

2 *Id.*, note 3, at 5.

3 *Id.* at 2.

4 *Id.*

5 *Starr Int'l Co. v. United States*, 109 Fed. Cl. 628 (Fed. Cl. 2013).

6 *Starr* (2015) at 2.

AIG's Descent into Crisis

Like other financial institutions at the time, AIG's difficulties originated with the financial crisis. Panic throughout the financial system caused the private market to stop working, and created a run on money market funds which in turn caused them to abandon commercial paper. The commercial paper market consequently went into shock, financial institutions stopped lending to each other and of the thirteen most important financial institutions in the United States, twelve had either failed or were at risk of doing so.[7] Of the factors that contributed to the crisis, the most prominent were the housing bubble caused by low interest rates and lax lending processes; increase in floating interest rates on subprime mortgages; misrepresentations of risk underlying securities such as collateralized debt obligations (CDOs) by rating agencies; transfer of mortgages by originators to others to facilitate the creation of CDOs (which led originators to make loans absent sufficient documentation as the risk of non-payment had been transferred); and failure of the alternative or "shadow" banking system (investment banks and broker dealers that originated loans and packaged them into securities for sale to investors) and the "repo" market (providers of overnight financing by means of repurchase agreements).

Concurrently, AIG, due to the securities lending program managed by its Financial Products Division, faced significant liquidity risks given the size and structural elements of its Credit Default Swap (CDS) portfolio, which at the end of June 2007 stood at $465 billion. To start with, AIG's CDS agreements provided that CDO managers could exchange pre-2006 Residential Mortgage Backed Securities (RMBS) with 2006 and 2007 subprime RMBS that were suspected of being less credit worthy. Further, AIG chose not to hedge the risks inherent to its multi-sector CDS contracts, despite CDS contracts which required AIG to post cash collateral given a default in a covered CDO, decrease in market value of a CDO, downgrade of a CDO tranche, or a downgrade of AIG itself by the credit rating agencies – the potential for which was made known to AIG in August 2008 on account of the volatility and deterioration in its earnings and financial condition.[8]

Subsequently, by Friday, September 12, AIG was struggling against crushing headwinds that threatened its survival. These included the likely downgrade of its credit ratings; a decline in its mortgage-related assets, and in its stock price, which fell from $22.76 to $12.14, or nearly 47% per share over the preceding week; an increase in CDS collateral calls and complete lack of market liquidity. That same day, AIG informed the FRBNY that it needed between $13 billion to $18 billion to satisfy its collateral demands, and in response was encouraged along with other private market participants to pursue a solution over the weekend, during which FRBNY staff undertook studies to assess AIG's financial condition, the pluses and minuses of lending to AIG, the consequences of AIG filing for bankruptcy and AIG's significance to the global economy.[9]

Over the weekend of September 13-14, AIG increased its projections of how much money it required to continue in operation as a going concern, from $18 billion initially to $45 billion on Sunday, September 14, and to $75 billion on Monday. On Sunday, AIG informed government officials that its efforts to find private sector funding were unsuccessful, as it was not able to find a private equity firm or sovereign wealth fund willing to provide financing in an amount and in the time frame necessary to stabilize the firm.

Then on Monday, September 15, the other shoe dropped when Lehman Brothers filed for bankruptcy. As a consequence, market liquidity tightened further, conventional financing became even more difficult to obtain, and AIG's counterparties started to withhold payments and refuse to transact with AIG even on a short-term, secured basis. On Monday and early Tuesday, bankers from Goldman Sachs and JP Morgan continued to work with other banks including Morgan Stanley to analyze AIG's need for liquidity and value, and to develop terms that might be attractive to other financial institutions. Their efforts proved to be in vain, however, given the view that the amount AIG needed to borrow was greater than its value by tens of billions of dollars.[10]

Notwithstanding, government officials were not disposed to let AIG file for bankruptcy given the perceived severity of the consequences on other financial institutions and the economy – which they expected would be far worse than the bankruptcy of Lehman.

The Bailout – Bait and Switch?

Having concluded that AIG could not be allowed to file for bankruptcy, the Board of Governors of the Federal Reserve met on September 16 to approve the term sheet for the loan to be granted to AIG. Included in the term sheet was a provision that the government would be compensated in part by warrants for the purchase of AIG common stock that represented 79.9% of AIG's common stock on a fully diluted basis.[11] The warrants were represented to the Board as being non-voting until exercised, having an exercise price, and requiring shareholder approval prior to issue. The terms also included a drawn interest rate of 12 percent, an undrawn fee of 8.5 percent, a 3 percent commitment

[7] *Id.*, at 8
[8] *Id.*, at 11.
[9] *Id.*
[10] *Id.*, at 12
[11] *Id.*, at 13.

Continued from p.15

fee on the total facility and a 2.5 percent periodic commitment fee payable in kind every three months subsequent to closing.[12]

AIG's Board met to consider the $85 billion credit facility the afternoon of September 16. The FRBNY gave the Board two hours to consider the offer, the terms of which were non-negotiable, and required that AIG's CEO be replaced. Deeming the risks of bankruptcy too high, the Board concluded that the loan was a better alternative, and approved two resolutions. The first authorized AIG to enter into a transaction with the FRBNY to provide a credit facility of up to $85 billion on terms described at the meeting, including the 79.9% equity participation comprised of commons stock warrants, and the second authorized AIG to enter into a $14 billion demand note and any additional notes in amounts needed to provide for the liquidity needs of the company.[13]

Contrary to the terms approved by the Federal Reserve Board of Governors, the government changed the terms of the equity participation. Specifically, although AIG's Board was led to believe that the Treasury Department would receive non-voting warrants, the form of equity participation was revised to convertible preferred voting stock with a 79.9% vote.[14] In addition to gaining voting rights, the Government was able to avoid paying a strike price of approximately $30 billion and gain control of AIG without a shareholder vote. Ultimately, the Government placed the preferred stock given to Treasury under the terms of the September 22, 2008 Credit Agreement in a trust (the AIG Credit Facility Trust) established for the benefit of the Treasury.[15]

Restructuring the Agreement

AIG eventually received an additional $100 billion in support, including $50 billion of new capital, and a $37.8 billion lending facility; however, AIG's financial condition still continued to deteriorate. As a consequence, and in recognition that the terms of the September 22, 2008, Credit Agreement were "onerous and counterproductive," the Agreement was restructured in November 2008. The new credit facility included a $40 billion capital contribution from the Troubled Asset Relief Program, a 5.5% reduction in the drawn interest rate, a reduction in the undrawn interest rate to 0.75%, an extension of the term of the loan from two to five years, the transfer of AIG's RMBS from its securities lending portfolio to a special purpose vehicle (Maiden Lane II) and the creation of an additional special purpose vehicle (Maiden Lane III), to eliminate AIG's CDS posting obligations and related liquidity risks.[16]

In return for the $40 billion TARP contribution, the Treasury Department bought AIG's Series D Preferred Stock, the terms of which were more burdensome than other equity received by the Treasury with TARP. In particular, AIG's Series D stock paid an annual dividend to the Government of 10 percent. By comparison, the annual dividend on $125 billion in preferred stock purchased by the Treasury Department from "eight of the country's largest financial institutions" was 5 percent.[17]

Through Maiden Lane III, the FRBNY and AIG were able to purchase $62.1 billion in par value of CDOs from AIG's counterparties and terminate the related CDSs, thereby eliminating the risk of collateral calls from AIG's CDS portfolio. This resulted in a net profit to the Government of roughly $6.6 billion including $737 million in interest. Similarly, the Government used Maiden Lane II to purchase and then sell $19.8 billion of AIG's RMBS, which generated a net profit of $2.8 billion including the cash flow produced while the securities were held in the portfolio. AIG's counterparties also benefited, receiving approximately $29 billion in payments from the Government before all was said and done.[18]

Cost of Ending Government Involvement

AIG's stock price continued to trade at a low value subsequent to the September 2008 Credit Agreement, closing at times below $1.00 per share, posing a risk that AIG might be delisted under NYSE rules. Consequently, AIG solicited and obtained shareholder approval at its June 30, 2009 annual shareholder meeting to implement a reverse stock split of issued shares at a ratio of twenty-to-one. The effect of the action was to make available nearly 5 billion shares of common stock for future issue, which if distributed would dilute the percentage ownership interests and voting rights of existing shareholders.[19]

The idea to move forward with an exchange of the Government's Series C preferred stock was first considered in 2010 when AIG started to assess avenues for ending the Government's involvement in its business in order to improve its credit rating and obtain private capital otherwise unavailable given its Government obligations. After a period of extensive negotiations, the Government and AIG signed a term sheet intended to accomplish AIG's objective on September 30, 2010. Under the terms of the recapitalization, made possible by the twenty-to-one reverse stock split, three series of preferred stock (Series C, E and F) were exchanged by the Government for AIG common stock.[20]

Following on January 14, 2011, AIG paid the FRBNY $21 billion in cash, an amount which terminated and satisfied the Credit Facility in its entirety, and resulted in a profit to the government of $6.7

12 *Id.*
13 *Id.*, at 14.
14 *Id.*, at 16.
15 *Id.*, at 18, 19.
16 *Id.*, at 20, 23.
17 *Id.*, at 21.
18 *Id.*, at 23.
19 *Id.*
20 *Id.*, at 24.

billion. In the process of the stock exchange, the Government also acquired 92.1 percent of AIG's common stock. Then on January 19th, AIG issued ten-year warrants to existing shareholders having a strike price of $45, representing a 26.2% market premium. Between May 24, 2011 and December 14, 2012, the Government sold 1,655,037,962 shares of AIG common stock, realizing a total of $51,610,497,475. In addition, if the common stock received by the Government in exchange for Series C Preferred Stock were to be accounted for as being sold on a pro rata basis with the common stock it received in exchange for Series E and F Preferred Stock, the dollar equivalent would be $17.6 billion. The only payment by the Government to AIG, however, was the $500,000 in loan forgiveness that the FRBNY gave AIG in September 2008. In the final accounting, the Government received all of the money that was given to AIG, whether from the Federal Reserve, TARP or elsewhere, plus a profit of approximately $23 billion.[21]

Starr's Challenge and the Government's Rebuttal

In the litigation brought by Starr to challenge the legality of the Government's actions, the Court commenced a 37-day trial in Washington, D.C. in which 21 witnesses testified on behalf of Starr, and 15 on behalf of the Government. Each of the parties offered testimony by four experts. Starr's experts presented testimony concerning:[22]

1. the adverse effects of market forces underlying AIG's liquidity and the impropriety of its treatment by the Federal Reserve;
2. the value of damages to the Credit Agreement ($35.4 billion, $13.16 per share) and Reverse Stock Split ($4.33 billion) classes using a market-based approach;
3. prejudgment interest rates of 7.0 percent to the Credit Agreement Class and 20.1 percent to the Reverse Stock Split Class based on a rate of return on a synthetic portfolio made up of competitors to AIG; and
4. factors that demonstrated the Government's effective economic control over AIG.

In rebuttal, the Government's experts testified that:[23]

1. effective economic control by the Government did not make AIG worse off;
2. the difference between warrants and preferred stock is not such that the equity participation terms of the September 22, 2008 Credit Agreement differed materially from those approved by AIG's board on September 16, 2008;
3. the primary goal of the reverse stock split was to increase AIG's stock price despite the fact that it did not reduce the number of authorized shares;
4. prejudgment interest, if applicable, should be awarded at 0.5 and 0.3 percent, or 2.9 and 3.2 percent, to the Credit Agreement and Reverse Stock Split Classes, respectively, using a risk-free rate of interest derived from one-year Treasury Bills and five-year Treasury Inflation Protected Securities;
5. AIG's shareholders were not damaged by the Government's rescue;
6. it was necessary for the Government to obtain an equity interest to compensate for the risk of lending to AIG;
7. share dilution does not result in economic loss; AIG was subject to significant liquidity risk caused by factors unique to AIG;
8. AIG's stock price never approached the $13.16 per share ascribed to the Credit Agreement Class; and
9. there were no damages to the Reverse Stock Split Class as a consequence of increasing the number of authorized and unissued shares.

AIG Stock Price

Source: WSJ Market Data Group

The Court's Decision

The Court concluded in favor of Starr's illegal exaction claim.[24] In doing so, the Court explained that given the approval of the Board of Governors, the FRBNY had the authority to act as a lender of last resort in times of "unusual and exigent circumstances," and to set a rate of interest with a view toward facilitating commerce. The Federal Reserve Bank was not, however, authorized under the Federal Reserve Act to acquire or take a borrower's equity as consideration for a loan. Similarly, the Court found nothing in the Federal Reserve Act or any other federal statute allowing a Federal Reserve Bank to take over a private enterprise and operate it as if it were the owner by demanding the replacement of its CEO and taking control of its operations, which is precisely what the FRBNY did in the case of AIG. Thus, finding that the Government's takeover of AIG was unauthorized, the Court however ruled that Starr's taking without just compensation claim must fail, since a claim cannot be both an illegal exaction and a taking based on authorized action.

With respect to damages, the Court reasoned that since Starr's claim for damages to shareholders was based on AIG's stock price at September 24, 2008, the first trading day during which the stock market learned of the material terms of the Credit Agreement, awarding damages on that benchmark would improperly require shareholder compensation to be measured against a stock price that the Government itself helped to create by virtue of its $85 billion loan to AIG. Further, the Court found that but for the intervention of the Government, AIG would have filed for bankruptcy, with the result being that its shareholders would have lost 100 percent of their stock value. Accordingly,

[21] *Id.*, at 25.
[22] *Id.*, at 29.
[23] *Id.*, at 30.
[24] *Id.*, at 34-39.

Continued from p.17

the Court concluded that neither the Credit Agreement Class nor Reverse Stock Split Class was entitled to recover damages, noting that "…however harshly or improperly the Government acted in nationalizing AIG, it saved AIG from bankruptcy. Therefore, application of the economic loss doctrine results in damages to the shareholders of zero."[25]

Conclusion

Commenting on the opinion of the Court of Federal Claims shortly after its issue, Federal Reserve Chair Janet Yellen stated that the actions of the Government "were legal, proper and effective" and that "We believe that the terms of that intervention were tough and appropriately so to protect taxpayers." Regardless, both the Government and Starr have filed notices of appeal, with Starr seeking damages and the Government seeking to overturn the Court's ruling that the Federal Reserve exceeded its authority in demanding ownership of AIG in exchange for the $85 billion loan. Resolution of the debate will be critical to the development of policy regarding at what time and in what form the Government should provide liquidity to support troubled financial institutions.

[25] *Id.*, at 40-41.

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Bankruptcy Taxes

Incorporating an Insolvent Partnership to Receive Excluded Cancellation of Indebtedness Income

PETER ENYART, SECTION EDITOR
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Legal and tax advisors frequently suggest incorporating insolvent partnerships during pre-bankruptcy debt workouts for different reasons. One reason to incorporate the partnership is to obtain tax relief on future cancellation of indebtedness income (CODI). In general, an insolvent corporation is eligible to exclude CODI from taxable income (the insolvency exception), whereas the exclusion for insolvency involving a partnership is determined at the partner level and not at the partnership level. Frequently these same advisors have little visibility into the financial health of all the partners to help determine whether the partners would be exempt from the taxation of CODI. As a result, the advisors suggest incorporating the partnership when they know the newly incorporated business would in fact be insolvent, thinking the corporation will obtain tax relief from the insolvency exception. This article will discuss some of the limitations and issues that must be considered prior to incorporating a partnership to avoid recognizing CODI, specifically the anti-abuse rules under I.R.C. section 269.[1]

Background of the Insolvency Exception

A cancellation of indebtedness generally results in taxable income to the taxpayer debtor.[2] As a result, prior to such discharge advisors will seek opportunity to alleviate income tax consequences of the discharge. One area of relief is the insolvency exception, which will exclude the CODI to the extent the taxpayer is insolvent. For this purpose, insolvency is measured as the total amount of liabilities in excess of the fair market value of the total assets. However, the application of the insolvency exception differs for a business, depending on whether the business is structured as a partnership or corporation for federal income taxes.

A corporation is eligible to exclude its CODI to the extent the corporation is insolvent immediately before the discharge[3], but in the case of a partnership, insolvency is determined at the partner-level rather than at the partnership.[4] Therefore, the CODI will be taxable to all of the solvent partners. In recent years, the Internal Revenue Service (IRS) has ruled that a partner's share of the partnership's excess nonrecourse debt is factored in the determination of the partner's solvency level, increasing the likelihood the partner will be insolvent[5] (see Jonathan Baker's article titled 'Financially Troubled Partnerships and the Allocation of Liabilities' below). Yet even with these favorable rulings, the partnership's advisors are often not familiar enough with the financial health of each partner to comfortably expect that CODI will be excluded from each partner's income. This uncertainty with respect to the partners often drives the idea that a partnership can merely incorporate and then receive the tax benefits awarded to corporations. Before incorporating a partnership for income tax purposes, the following limitations imposed under section 269 must be considered.

Section 269 May Result in Disallowance of the Insolvency Exception

Section 269 is an anti-abuse provision of the Internal Revenue Code (the "Code") that provides the IRS with the ability to potentially disallow federal income tax benefits when "the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax."[6] For purposes of this section, a tax benefit is defined very broadly. These benefits include a deduction, credit and other allowance. The regulations further describe an allowance to include among others a deduction credit, adjustment, exemption, or exclusion (emphasis added).[7] It is therefore clear that the exclusion provided under section 108 falls within the definition of allowance for purposes of section 269 and is at-risk for disallowance from the IRS. As a result, advisors must understand the conditions needed for section 269 to apply when incorporating a partnership, in order to determine whether the insolvency exclusion is at risk when a partnership incorporates.

When incorporating a partnership, section 269 can apply when: (1) any person or persons acquire, directly or indirectly, control of a corporation; and (2) the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy. Both conditions must be present for section 269 to apply.

Condition 1: Control For purposes of section 269, the acquisition of "control" means the ownership of stock by persons possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation.[8] A "person" can include an individual, trust, estate, partnership, association, company, or corporation.[9] Thus "person" is not limited to natural persons as is often thought (consider differences among other definitions of person in the Code, such as under section 382). The form of the incorporation (e.g., assets-over vs. assets up) would not seem to matter for section 269, since both the partnership and the partners could be included as persons. Additionally, no

[1] Unless otherwise noted, all references to Code sections pertain to the Internal Revenue Code (26 U.S.C.).
[2] § 61(a)(12).
[3] §108(a)(1)(B).
[4] §108(d)(6).
[5] Rev. Rul. 2014-14.
[6] § 269(a)(2).
[7] Treas. Reg. § 1.269-1(a).
[8] Treas. Reg. § 1.269-1(c).
[9] Treas. Reg. § 1.269-1(d).

differentiation is made with regard to whether the incorporation is a taxable transfer of assets (section 1001) or tax-free transfer of assets (section 351). Therefore, an incorporation of a partnership, where the partnership or the partners acquire at least 50 percent of the voting power or total value of the newly incorporated corporation, would meet the condition of control under section 269.

Condition 2: Principal Purpose Is to Evade or Avoid Federal Income Tax Assuming the condition of control described above is satisfied, section 269 will apply if the principal purpose of acquiring the corporation is to evade or avoid federal income tax. The regulations state, "the determination of the purpose for which an acquisition was made requires a *scrutiny* of the entire circumstances in which the transaction or course of conduct occurred, in connection with the tax result claimed to arise therefrom (emphasis added)."[10] Therefore, the tax benefits received as a result of the partnership incorporation are in jeopardy if the IRS determines those benefits were the principal purpose of the incorporation.

As emphasized above, the IRS will scrutinize the entire circumstances in which the partnership incorporated. This is a facts and circumstances analysis which provides no safe harbor. Apart from income taxes, there are an abundance of business reasons why a partnership may incorporate, including but not limited to: (1) providing increased liquidity for ownership and assisting in raising additional equity; (2) providing limited partners to participate in the management of the business; and (3) providing limited liability to general partners. Therefore, it is paramount that a strong, nontax business purpose for incorporating the partnership exists. However, even that is not sufficient as it must be the principal purpose and not just merely present. Further, and although somewhat obvious, the nontax reason for incorporating must be acted upon and not simply a narrative.

In evaluating the purpose(s) of incorporating the partnership, the timing of the incorporation should be considered in connection with other significant subsequent events, such as the debt's discharge or liquidation. In the most extreme (and not all that unlikely) case, a partnership will incorporate, have its debt cancelled, and then liquidate its remaining assets in satisfaction of the debt, all in relatively short order. In such a fact pattern, the IRS may disregard the incorporation altogether, thereby eliminating the benefits of the insolvency exception to the corporation. The greater the length of time between incorporation and the discharge or liquidation, the stronger the case for arguing that nontax business reasons were the principal purpose of incorporating. Keep in mind, a corporation may experience several tax disadvantages that are not otherwise incurred by a partnership. Although beyond the scope of this article, some of these disadvantages include double taxation on corporate earnings and inability to allocate losses to owners.

Can there be more than one principal purpose for incorporation? It would seem, based on the literal reading of "the principal purpose" (as opposed to a principal purpose or substantial purpose) that there can only be one principal purpose. An interpretation of the Supreme Court's ruling in *Malat v. Riddell*[11] (not a section 269 issue), suggests the term "primarily" means "of first importance" or "principally," which seemingly supports the theory that there can be but one principal purpose; thus section 269 should apply only when the tax purpose outweighs any other nontax business purpose. However, tax commentary suggests other areas of the law cloud this certainty by providing that a principal purpose need only be a factor that weighs heavily in the decision to incorporate.[12] Although section 269 refers to just one principal purpose, the uncertainty here suggests a larger potential for its application.

Regardless, to minimize the risk of coming under the second condition for section 269 to apply – that the principal purpose of incorporation was evasion or avoidance of federal income tax – advisors must carefully examine the purpose(s) for incorporating and ensure that facts and circumstances indicate tax motivations are at least less consequential than nontax business purposes.

Conclusion

Limited liability companies (LLCs) are likely the most common type of partnership. The ability to easily "check the box" and incorporate an LLC for income tax purposes creates an attractive option for taxpayers seeking to exclude CODI generally available to insolvent corporations. However, taxpayers, as well as their legal and tax advisors, need to be aware that section 269 may eliminate the corporate insolvency exception under section 108, if the principal purpose of incorporating is to evade or avoid federal income tax. As a result, the application of section 269 needs to be closely examined to determine if at least one condition – control or principal purpose – is failed, in order to ensure no tax benefits are disallowed as a result of the incorporation under section 269.

[10] Treas. Reg. § 1.269-3(a).

[11] 383 U.S. 569 (1966).

[12] *See* 29 U.S.C § 1392(c) ERISA and the various authorities thereunder.

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Financially Troubled Partnerships and the Allocation of Liabilities

JONATHAN BAKER
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The allocation of partnership liabilities can have a very significant impact on the taxation of the partners of the partnership. This can be especially true in the context of a financially troubled partnership. If a partnership restructures its debts, it will likely generate discharge of indebtedness income to the extent debt is relieved.[1,2] This income may be eligible for exclusion, but eligibility for this exclusion is determined at the partner, as opposed to the partnership, level.[3] Since the amount of liabilities allocated from a partnership may have a significant impact on a partner's ability to claim insolvency exclusion, it is important to understand how these liabilities are allocated and keep an eye out for unintended consequences of these allocations when considering restructuring the liabilities of a financially troubled partnership.

Partnership Basics

It may be helpful to walk through some of the basics of how partnerships and partners are taxed to understand how the allocation of liabilities can impact a partner in the face of a debt restructuring or bankruptcy. In general, a partnership is not a taxable entity,[4] but instead all the income, deductions and other tax attributes of the partnership "flow through" to the partners, who bear the burden of paying income taxes on their allocable share of partnership income.[5] This flow through, or conduit, approach also applies to partnership liabilities. [6]

The allocation of liabilities can be extremely complex and is beyond the scope of this article, but in general, recourse liabilities (in this context defined as a partnership liability that a partner or related person bears economic risk of loss for that liability[7]) are allocated to the partner that bears the economic risk of loss for that liability, and nonrecourse debts (in this context defined as a liability where no partner or related party bears the economic risk of loss with respect to that liability[8]) are generally allocated in accordance with a partner's allocation of partnership profits or deductions. This is an oversimplification of what can be a very complex determination, but for the purposes of this article this should be sufficient.

A brief discussion of the impact of the allocation of liabilities on partners is also warranted. Partnership liabilities that are allocated to a partner provide that partner with basis in his partnership interest.[9] To the extent there is an increase in a partner's share of partnership liabilities, that partner is deemed to have contributed cash to the partnership equal to the increase in his share in the partnership liabilities, which will correspondingly increase the basis in his partnership interest.[10] A decrease in a partner's share of liabilities, on the other hand, creates a deemed cash distribution to the partner, with a corresponding reduction in basis.[11] This deemed cash distribution may create gain recognition for the partner.[12]

Determination of Discharge of Indebtedness Income

That a discharge of indebtedness constitutes income was determined by the Supreme Court in the 1930's, and subsequently codified into the Internal Revenue Code.[13] Oftentimes, the amount of the discharge is relatively easily determined (by the reduction of the amount owed), though in situations where part of the debt is exchanged for interests in the partnership valuation issues may make the amount of the discharge harder to determine. This income is determined at the partnership level, and then that discharge of indebtedness income is allocated to the partners in accordance to their allocable share of partnership income.

Reduction in Partnership Liabilities

The reduction in partnership liabilities that results from the discharge of indebtedness will also cause a reduction in the allocation of partnership liabilities to the partners. This will cause the partners to receive a deemed cash distribution to the extent their share of partnership liabilities are reduced by the discharge, with a corresponding reduction in the basis of their partnership interest and potentially gain recognition as discussed above.

When the increase in basis as a result of the discharge of indebtedness income is combined with the decrease in basis from reduction in a partner's share of partnership liabilities, it appears this should net to zero and discharge of indebtedness should not result in a change in a partner's basis. However, this assumes allocation of income and liabilities are in lockstep, which is not always the case, especially with respect to recourse debts. Consider a partnership where A and B are partners and share profits and losses equally. The partnership has $1 million in debt, which is recourse only to A. As a result, all of the partnership liabilities ($1 million) are allocated to A. If, as a result of a workout, the debt is reduced to $800 thousand, the partnership would recognize $200 thousand in discharge of indebtedness income. This would be split evenly between A and B; however, the reduction of liabilities would only be picked up by A, who was allocated all of the partnership liabilities. The net result is a reduction in A's basis by $100 thousand (an increase of $100 thousand from the discharge of indebtedness income and a reduction of $200 thousand as a result of the reduction of A's allocable share of the partnership liabilities). B, on the other hand, will see his partnership basis rise by $100 thousand as a result of the discharge of indebtedness income. This potential for disconformity between discharge of indebtedness income and partnership liability allocation can create income recognition unexpectedly.

Exclusion of Discharge of Indebtedness Income

There are a number of situations when a taxpayer may exclude discharge of indebtedness income from their taxable income, including when a taxpayer is subject to a bankruptcy under chapter 11 of the U. S. Bankruptcy Code ("chapter 11") and when the taxpayer is insolvent.[14] As mentioned above, the determination of

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(d)(6).

4 §701.

5 §§701, 702(b).

6 §752(a).

7 §1.752-1(a)(1).

8 §1.752-1(a)(2).

9 §752.

10 §752(a), §1.172-1(b).

11 §752(b), §1.752-1(c).

12 §§731(a), 751(b).

13 *United States v. Kirby Lumber Co*, 284 US 1 (1931), §§108(e)(1) 61(a)(12).

14 §§108(a)(1)(A),(B).

a taxpayer's ability to exclude discharge of indebtedness income is determined at the partner, as opposed to the partnership, level.[15] The determination of whether a partner is subject to a chapter 11 bankruptcy case is generally a straightforward determination of whether the partner has filed for chapter 11 bankruptcy or not. However, there is some authority that a partner need not be the debtor in a chapter 11 proceeding to be able to utilize this exclusion.[16] In this case the bankruptcy court specifically took jurisdiction over a general partner of a partnership that had filed chapter 11 bankruptcy proceeding. The IRS has not acquiesced with this case, so there is risk in excluding income of a partner based on merely being subject to the jurisdiction of the Bankruptcy court.

For purposes of the insolvency exclusion, insolvency is defined as the excess of the taxpayer's liabilities over the fair market value of the taxpayer's assets determined immediately before the discharge.[17] However, to the extent a debtor is made solvent by the debt discharge, the debtor recognizes income to the extent the fair market value of the taxpayer's assets exceed the value of the taxpayer's liabilities immediately after the discharge.[18] This in effect limits the exclusion to the amount of the insolvency. To determine a partner's insolvency, one must take into consideration the partner's allocable share of (1) recourse liabilities, (2) nonrecourse liabilities to the extent of the fair market value of the property which secures the nonrecourse debt, and (3) excess nonrecourse liabilities that are discharged.[19] Excess nonrecourse liabilities are defined as nonrecourse liabilities in excess of the fair market value of the property securing that debt.

Example

Consider partnership X with two equal partners, C and D. Partners C and D are equal partners and share profits and losses equally. Partnership X has only one asset, which was acquired in year 1 for $100 and is subject to a nonrecourse note of $100. Assume this note is allocated $50 each to C and D. In year 2, assume that the value of the property has decreased to $80, and the bank that provided the nonrecourse note has agreed to modify the note and reduce the outstanding principal to $90. Further assume that C has no other assets or liabilities, and that D has other assets valued at $50. In year 2 at the partnership level, $10 of discharge of indebtedness income is created, which is allocated equally between C and D. In addition, both C's and D's shares of partnership liabilities are reduced.

To determine whether C is insolvent, C's liabilities include his allocable share of partnership nonrecourse liabilities to the extent of the fair market value of the assets by which they are secured, $40 (50% of $80, the extent of the nonrecourse liability secured by the property with a value of $80), plus $5 (C's allocable share of excess nonrecourse liabilities) for a total of $45. C's only asset is his share of the sole asset of partnership X, with a value of $40 (50% of its $80 fair market value). C is insolvent to the extent $45 exceeds $40 and can exclude $5 dollars of discharge of indebtedness income. Partner D, due to his other assets, would not be considered insolvent and would not be able to exclude the discharge of indebtedness income.

Now consider the same example, but where the $100 note is considered recourse to partner D. Partner C is now considered solvent, because C has an asset, but no liabilities. As a result C will not be able to exclude the $5 of discharge of indebtedness income allocated to him. D on the other hand will be considered insolvent. He will have liabilities totaling $90 (the recourse liability) and assets of only $40 (his share of the partnership asset). D will be able to exclude the discharge of indebtedness income as a result.

Conclusion

As is illustrated in the above examples, how partnership liabilities are allocated can have a dramatic impact on the ability of a partner to exclude discharge of indebtedness income. This requires careful attention when considering debt restructuring in the partnership context, to avoid unintended consequences and income recognition. Thought should also be given to how the reduction of liabilities may shift partnership liability allocation, which even in the absence of debt discharge income can cause a partner to recognize income, as well as the potential for mismatches between allocation of debt discharge income and liability allocation.

[15] §108(d)(6).
[16] *Gracia v. Com'r*, TC Memo 2004-147.
[17] §108(d)(3).
[18] §108(a)(3).
[19] Rev. Rul. 2012-14.

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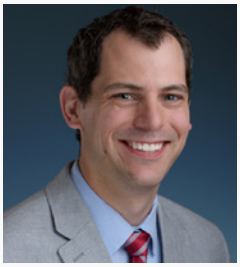

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