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Article 9 Amendments, Again, Already!

How the 2013 Changes Will Affect Insolvency and Restructuring Advisors

Part One: The Debtor's Name[1]

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INTRODUCTION

Changes to Article 9 of the Uniform Commercial Code (UCC) were proposed by the American Law Institute and the Uniform Law Commission in 2010,[2] with a uniform effective date, July 1, 2013. The amendments have already been adopted by the majority of United States jurisdictions and, although some rules will take effect over a transition period, it is not too soon for insolvency and restructuring advisors to understand the new rules and to apply them in management of their cases.

This is the first part of a series to be presented in *AIRA Journal*. Future articles will deal with a range of other changes: the rules related to location of the debtor; the still-awkward rules governing naming and filing when a trust is the debtor; the form of the financing statement; new "information statements," which may or may not help clarify the record; filings that are made prior to closing; filings when the debtor is a "transmitting utility"; organizational changes in corporations; chattel paper; classification of collateral; and remedies. This series will not be a complete analysis of all the 2013 changes. For example, it will exclude issues of importance primarily to creditors in intramural priority disputes. However, it will focus on issues of greatest interest to insolvency and restructuring advisors. In several instances, these simplify the task of evaluating secured claims and identify problems that all parties to the bankruptcy process should anticipate.

A BRIEF HISTORY OF THE 2013 AMENDMENTS

In 2001, Article 9 of the Uniform Commercial Code was extensively amended in all the states. After a lengthy drafting process, both the American Law Institute and the Uniform Law Commission proposed additional amendments in 2010[3] and published them for adoption by the states, with a uniform effective date of July 1, 2013.[4] A number of the changes are in the commentary rather than the statute, with the drafters having chosen to amend a comment over an amendment to the existing statute, if a change could be so addressed. There are also revised national Financing Statement (UCC-1) and Amendment (UCC-3) forms, which are part of the statute[5] and were developed with the International

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[1] Portions of this article were adapted from *Article 9 Amendments, Again, Already? How the 2013 Changes will Affect Trustees*, by Lawrence R. Ahern, III, which first appeared in NABTalk, the Journal of the National Association of Bankruptcy Trustees, Spring 2013, Volume 29, Issue 1, pp. 20-31 & 64, and were adapted by permission of NABT. Other portions were adapted from the *Bankruptcy Procedure Manual*, *The Law of Debtors and Creditors*, and other works published by Thomson Reuters (West Publishing), and are used here with permission. This series of articles is also the basis for a pending book by the author and William Houston Brown, summarizing secured creditors' rights in bankruptcy after 2013. Thanks also to Darlene Marsh, Burr & Forman, for her extremely valuable critique of these articles, and to the ABI's "Volo" project for reports of circuit court bankruptcy-related decisions. For more information about these publications, go to http://west.thomson.com/store, http://volo.abi.org and www.nabt.com. Reprint requests may be directed to the author, LRAhern@Comcast.Net, 615-579-2542.

[2] The final version of the 2013 Amendments is Appendix V to Article 9 and is copyrighted but appears on Westlaw in the UCC-TEXT database and on other online research databases.

[3] The extensive revisions proposed in 1998 were adopted almost universally with a uniform effective date of July 1, 2001, and may be referred to as the "2001 Revision." The amendments adopted in 2010, effective July 1, 2013, have not yet been adopted by all jurisdictions but will similarly be referred to as the "2013 Amendments." Where the partially-revised portions of the 2013 Amendments are quoted in the text and in these footnotes, deletions from the pre-2013 version are ~~stricken through~~. Unless it is clear that some text is entirely new, additions are shown by *italics*.

[4] At the deadline for this article, at least 36 jurisdictions had adopted the 2013 Amendments, most had included the July 1, 2013 effective date and all but two additional jurisdictions appeared to have introduced the amendments. Basic information is available on the website of the Uniform Law Commission. <http://www.uniformlaws.org> (last visited April 28, 2013). Legislative status reports are also available elsewhere, such as the website of the Corporation Service Company. <http://csctransactionwatch.com/amendments> (last visited April 28, 2013).

[5] UCC § 9-521. (Unless otherwise specified, citations are to the revised commentary and amended Code, effective 2013.)

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A Letter from the President

Anthony V. Sasso, CIRA
Deloitte CRG

Hello again. It is hard to believe, but a year has passed, putting me halfway through my term as President. It has been a great year for AIRA, culminating with the conclusion of our annual conference on June 8th. One more year to go and luck and timing has me slated to preside over next year's 30th Annual Conference in Denver, June 4- 7, 2014 (it's never too early to mark your calendars!).

29th Annual Bankruptcy & Restructuring Conference – For those who attended this year's conference in Chicago, I trust the hard work put in by all the conference chairs, planning committee, speakers and the AIRA team in developing and delivering the program was evident in your experience. I hope you received all the benefits we strived to bring to this year's conference: rich educational experiences, opportunities to network and build friendships, and just an overall good time.

Special thanks to our keynote speakers, including **Camisha L. Simmons**, an associate with Fulbright & Jaworski, who spoke on "Emerging Healthcare Privacy Concerns in Bankruptcy"; **Bob Wiedemer**, economist and author of *America's Bubble Economy*, *Aftershock* and *The Aftershock Investor;* **Grant Achatz**, world-renowned chef and restaurateur, who explored the role of innovation in the design of a business model; and **Lynn Osmond**, president of the Chicago Architecture Foundation, for a fascinating glimpse into the history of architecture in downtown Chicago.

As to other activities, the "Windy City" briefly became a bit of a "Rainy City," but not enough to keep participants from enjoying the excursions. The golf outing, architecture river cruise, Segway tour, cooking class and White Sox game experienced great turnout and minimal weather issues.

Manny Katten Award – I had the pleasure of presenting this year's award to my good friend and past president, **Alan Holtz** of AlixPartners, for his many years of contribution to the organization's success (read more about Alan on the next page.)

New Endowment Fund – In my inaugural letter last year I extended special thanks to **Grant Newton**, AIRA Executive Director, for his many years of service to the AIRA. A couple of years ago, long time Board member Matt Schwartz of Bederson & Company LLP initiated the idea of a scholarship fund in Grant's name. Over the past year the idea gained steam and a committee headed by Matt Schwartz, Gina Gutzeit, Joel Waite and Grant Stein pushed it to fulfillment. At the annual banquet, I believe we managed to truly surprise Grant when we announced the AIRA Grant Newton Educational Endowment Fund, presenting him with an opening contribution of $50,000 in his honor.

The AIRA Staff – As I did last year, I would like to recognize the AIRA staff, not only for their efforts in managing this year's annual conference, but for their contributions to the organization's success throughout the year. Current members include Terry Jones (Director of CIRA and CDBV Programs), Cheryl Campbell (Associate Executive Director), Lorren Biffin (Director of Creative Services), Elysia Harland (Controller), Valda Newton (Executive Assistant), Michele Michael and Mary Hamilton (Administrative Assistants), and Danae Newton (Conference Assistant).

Thank you again and I look forward to seeing you at an AIRA event soon!

Tony Sasso

P.S.—See Photo Gallery from the Annual Conference at www.AIRA.org/2013-ac-gallery

Executive Director's Column

Grant Newton, CIRA
AIRA Executive Director

2013 MANNY KATTEN AWARD PRESENTED TO ALAN HOLTZ

As many readers will know, this award was named in memory of Manny Katten, a member of the founding Board of Directors of the AIRA (previously AIA), and former partner of Arthur Andersen. In his honor, the Manny Katten Award is presented each year in recognition of outstanding contributions to the profession and the AIRA.

Alan Holtz was chosen by AIRA's Board of Directors as this year's recipient of the Manny Katten Award. The award was presented during the annual dinner on July 6th at The Westin Chicago River North during our 29th Annual Conference.

Alan's involvement with the AIRA goes back to 1991, the initial year of the CIRA program. Alan sat for the CIRA exam during the inaugural year and not only passed but was the Silver Medal winner.

Alan was on the Board for 10 years and has always been an active member and leader. After the Annual Conference, AIRA's most successful program has been the annual Advanced Restructuring and Plan of Reorganization Conference in New York (usually referred to as "POR" or "NYPOR"). Alan was responsible for putting the first conference together in the fall of 2002 along with chairing the conference in subsequent years (the 11th POR took place last fall).

Alan was Vice President of the CIRA program for several years. He focused on promoting the program and contributing to growth in the number of CIRAs. After his term as Vice President, Alan served as President from June 2006 to June 2008, and then as Chairman from June 2008 through June 2010.

Over the years, in addition to his work on the Board, Alan has made many other significant contributions to the AIRA, including an active role in planning our annual conferences, arranging speakers, speaking on panels, writing articles for the AIRA Journal and so on. While at E&Y and later through AlixPartners, he also maintained active sponsorships of AIRA events each year and Alan's successors from AlixPartners continue to be strong supporters of the organization.

Current AIRA President, Tony Sasso, made the following comments on Alan's term as president before presenting him with the award (see photo, Alan Holtz and Tony Sasso, from left):

> "All members of the Board are proud of the organization we represent, and the typical two-day winter Board meeting is a time where we cover many important matters for the upcoming year. And while we get done what is necessary to get done, many of us are also waiting for the bell to ring so we can "go out and play," so to speak. But when Alan became president, he [took] it to a whole new level, breaking us out into working groups with "EXTRA homework" on how to drive up membership, increase quality and quantity of our offerings, and so on. At times, I started to feel like I was going through a continuous improvement exercise at a Japanese automobile factory. You see, Alan as someone who is all about trying to do a very good job even better the next time."'

I truly enjoyed getting to know Alan over the years. It didn't matter whether it was official business such as AIRA Board meetings, working on committees and planning conferences, or a rare opportunity to relax and catch up on things. We truly appreciate Alan's many contributions and miss having him on the Board. ■

To contribute to the newly established

AIRA Grant Newton Educational Endowment Fund

contact Elysia Harland, eharland@aira.org

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Association of Corporation Administrators (IACA). Those forms now take into account some of the substantive changes, including significant new rules for naming debtors, which are critical for proper perfection of a security interest.

DEBTORS' NAMES

Interplay of UCC Article 9 and the Bankruptcy Code's "Strong Arm" Power

Section 544(a)(1) of the Bankruptcy Code[6] provides "strong arm" power to the trustee in bankruptcy and debtor in possession (DIP) in Chapter 11,[7] with those fiduciaries being given the status of hypothetical judicial lien creditors as of the commencement of the bankruptcy case. These powers allow the estate to "avoid" any Article 9 security interest that is subordinate to such a creditor. Under Article 9 of the Uniform Commercial Code, this means the trustee or DIP can avoid a security interest that has not yet been perfected on the petition date.[8] In addition, belated perfection of a previously-unperfected security interest within the 90-day or one-year period prior to filing may expose the creditor to avoidance of its security interest as a preference under section 547. This is because the preference rules tie the date of the "transfer" to the date of perfection.[9] Only when the secured creditor can survive the attack of the hypothetical judgment lien creditor has the creditor received the potentially preferential "transfer." So, for example, if a loan is initially secured by an unperfected security interest (perhaps because the filing is defective) and the security interest is perfected later and within 90 days prior to bankruptcy, it may be vulnerable to avoidance as a preference. Because most security interests are perfected by filing a financing statement, the method of establishing compliance with the filing rules is essential in determining whether a security interest can be attacked.

A major revision of Article 9 in 2001 reduced the likelihood of making terminal errors in UCC-1 filings in two ways: First, the number of filings required for perfection was reduced after 2001.[10] Second, the types of errors that render the financing statement ineffective were reduced—only errors in the debtor's name, the secured party's name, or the indication of the collateral can render the financing statement ineffective as against the trustee or DIP.[11] Of the three, errors in the debtor's name generally provide the greatest opportunity for lien avoidance. To avoid a financing statement on the basis of such an error, the trustee/DIP must establish that the error "make[s] the financing statement seriously misleading."[12]

Correct Name

Since 2001, the rules have made it relatively easy for a secured party to determine the correct name for a registered organization (corporation or other entity with a document on file evidencing the fact of organization and, importantly, the name of the organization): A registered organization must be named using the name on the public record.[13] The rules pertaining to names of organizations have created some issues that will be addressed by the 2013 Amendments (and are discussed below), but they have been relatively minor in comparison to the problems encountered with names of individuals. Article 9 has until now done little to resolve the issues that can arise with respect to individuals' names. For example, it does not indicate whether a full "legal" name is required or whether a nickname or alias could be sufficient. Such problems are compounded by the often-deliberate limitations of computerized systems for searching records of filings.

The "Seriously Misleading" Standard

As explained in new commentary, an error in the debtor's name is not fatal unless it makes the financing statement "seriously misleading":

> Even if the name provided as the name of the debtor becomes insufficient under Section 9-503(a), the filed financing statement does not become seriously misleading, and Section 9-507(c) does not apply, if the financing statement can be found by searching under the debtor's "correct" name, using the filing office's standard search logic. See Section 9-506. Any name that satisfies Section 9-503(a) at the time of the search is a "correct name" for these purposes.[14]

Thus, for name errors, Section 9-506 imposes a standard based on the computerized "standard search logic" used by the relevant filing office.[15] An error in the debtor's name renders the filing ineffective if a search under the correct name, using that search logic, would not reveal the financing statement in question. The International Association of Corporation Administrators (IACA) has promulgated a set of Model Administrative Rules for Article 9 filing systems that has been adopted by numerous states.[16] Under these rules, the margin for error built into "standard search logic" around the United States has been small and a searcher's judgment plays no role in determining the search results. The computer retrieves, or fails to retrieve, a filing based on the precise search request and the filing database; even a minor misspelling or a typographical error in one character of the filed name can be fatal. In one case, for example, the debtor's name on a filing, "CW Mining Company," was found to be seriously misleading because

6 11 U.S.C. § 544(a)(1).

7 Unless and until a trustee is appointed, the debtor in possession is vested with all of the powers of a trustee that are relevant to this discussion. 11 U.S.C. § 1107(a).

8 See UCC § 9-317(a)(2).

9 11 U.S.C. § 547(e)(1)(B).

10 The filing systems for Article 9 transactions after 2001 include a broad commitment to centralized filing, establishing only one place in which a financing statement is generally filed in only one state and a filing system that takes the filing process from the universe of filed paper to that of electronic records. See, e.g., UCC §§ 9-301(6) (law governing perfection and priority) & 9-501 (place of filing). The only local filing of financing statements is for fixtures, timber to be cut and "as extracted" collateral (oil, minerals, etc.). See UCC § 9-501(a)(1).

11 See UCC § 9-502(a).

12 See UCC § 9-504.

13 UCC § 9-503(a)(1).

14 UCC § 9-507 Cmt. 4.

15 See UCC § 9-506(c).

16 See, e.g., "Programming Implementation Guide for Standard Search Logic," presented at the 2006 Conference of IACA, <http://www.iaca.org/iaca/wp-content/uploads/ProgrammingImplementationGuideforIACA_version1_-AsAdopted.pdf> (last visited April 29, 2013).

a search in the state records for the correct name, "C. W. Mining Company" (with periods after initials and spaces between), using the state's database search engine, did not retrieve the creditor's financing statements.[17] (See summary at right.)

Article 9 also contains detailed requirements for naming debtors, decedents' estates and trusts,[18] which are all affected to various extents by the 2013 Amendments. The name of an organization, if it has a name, is required even if it is not registered. If an organization does not have a name, the financing statement must name all partners, members or associates.[19] A secured party can add, as supplemental information, a debtor's trade name or the names of partners, members or associates (if those names were not required); however, the additional names are unnecessary and, without the correct name of the debtor, inadequate.[20]

Individuals' Names

Before the 2013 Amendments, Article 9 provided relatively little guidance on the naming of individual debtors. As one critical observer concluded at the time of the 2001 amendments:

> Does the trustee automatically win if the financing statement lists only "Rob Smith"? Not necessarily. The secured creditor could argue that "Rob Smith" is a "correct" name for the debtor. Revised Article 9 does not tell us whether that argument prevails.[21]

Practitioners and the courts have thus encountered significant problems since 2001 in determining the correct name for some debtors, especially individuals. Application of sections 9-503 and 9-507 has produced a great deal of litigation over the correct "name" of the debtor, nicknames and similar issues. At one end of the spectrum, a bankruptcy court held that a filing using "Mike D.," instead of "Michael D.," was insufficient.[22] At the other end, the Fifth Circuit Court of Appeals held that a filing in the name "Louie Dickerson" was sufficient although the debtor's actual name was "Brooks L. Dickerson."[23] The new rules, which are statutory changes in the 2013 Amendments, should give all parties—both drafters of documentation and bankruptcy professionals—clearer guidance to determine whether a security interest is properly perfected.

When proposing the 2013 Amendments, the drafters also provided several new suggestions for the courts, as they struggle to determine the proper names of individuals:

SUMMARY:

Importance of Name Searches

Because of the critical role of an accurate debtor's name in providing notice to third parties, Article 9 comes close to requiring rigid technical correctness. A financing statement that substantially complies with Article 9 is effective, even if it contains minor errors that are not seriously misleading. Failure to state the debtor's correct name is a seriously misleading error as a matter of law but a wrong name or the old name of a debtor with a new name is only seriously misleading if a search (using the filing office's standard search logic) under the correct name would not disclose the incorrect financing statement. The "search logic" that has been adopted by many filing offices since 2001 can be very strict. In order to determine whether a creditor is perfected, the insolvency and restructuring advisor should run a search in the correct name of the debtor, without alternatives, abbreviations, etc. If that search does not produce a report that includes the creditor's filing, the trustee/DIP may argue that the debtor's name on that filing is seriously misleading. Many rules clarified in the 2013 Amendments will make it easier to determine the correct name in which to conduct that search.

In disputes as to whether a financing statement sufficiently provides the "individual name" of a debtor, a court should refer to any non-UCC law concerning names. However, case law about names may have developed in contexts that implicate policies different from those of Article 9. A court considering an individual's name for purposes of determining the sufficiency of a financing statement is not necessarily bound by cases that were decided in other contexts and for other purposes.

Individuals are asked to provide their names on official documents such as tax returns and bankruptcy petitions. An individual may provide a particular name on an official document in response to instructions relating to the document rather than because the name is actually the individual's name. Accordingly, a court should not assume that the name an individual provides on an official document necessarily constitutes the "individual name" for purposes of the sufficiency of the debtor's name on a financing statement. Likewise, a court should not assume that the name as presented on an individual's birth certificate is necessarily the individual's current name.

In applying non-UCC law for purposes of determining the sufficiency of a debtor's name on a financing statement, a court should give effect to the instruction in Section 1-103(a)(1) that the UCC "must be liberally construed and applied to promote its underlying purposes and policies," which include simplifying and clarifying the law governing commercial transactions. Thus, determination of a debtor's name in the context of the Article 9 filing system must take into account the needs of both filers and searchers. Filers need a simple

17 *Rushton v. Standard Industries, Inc.* (*In re C.W. Mining Co.*), 2009 WL 2601246, 69 UCC Rep. Serv. 2d 830 (Bankr. D. Utah Aug. 24, 2009).

18 UCC § 9-503(a)(2) &(3).

19 UCC § 9-503(a)(4).

20 UCC § 9-503(b) & (c).

21 G. Ray Warner, "Using the Strong-Arm Power to Attack Name Errors under Revised Article 9, 20-OCT Am. Bankr. Inst. J. 22, 23 (2001).

22 *Farmers & Merchants State Bank* (*In re Larsen*), 2010 WL 909138 (Bankr. S.D. Iowa Mar. 10, 2010).

23 *Peoples Bank v. Bryan Bros. Cattle Co.*, 504 F.3d 549 (5th Cir. 2007). The drafters of the 2013 Amendments expressed specific criticism of this outcome at length, concluding with a new comment that "[s]uch a financing statement is ineffective even if the debtor is known in some contexts by the name provided on the financing statement and even if searchers know or have reason to know that the name provided on the financing statement refers to the debtor. Any suggestion to the contrary in a judicial opinion is incorrect." UCC § 9-506 Cmt. 2; see also UCC § 9-503 Cmt. 2.d.

> and predictable system in which they can have a reasonable degree of confidence that, without undue burden, they can determine a name that will be sufficient so as to permit their financing statements to be effective. Likewise, searchers need a simple and predictable system in which they can have a reasonable degree of confidence that, without undue burden, they will discover all financing statements pertaining to the debtor in question. The court also should take into account the purpose of the UCC to make the law uniform among the various jurisdictions. See Section 1-103(a)(3).[24]

The new comment concludes, however, with this suggestion, reflecting the continuing uncertainty surrounding these issues:

> If there is any doubt about an individual debtor's name, a secured party may choose to file one or more financing statements that provide a number of possible names for the debtor and a searcher may similarly choose to search under a number of possible names.[25]

So, when in doubt, even the drafters of the 2013 Amendments encourage secured parties to file in all names. This is an unfortunate conclusion, given the 2001 drafters' goal of eliminating multiple filings based, at least, on the location of collateral.

Alternative A – "Only If" Rule

The 2013 Amendments provide two alternatives, A and B, in section 9-503(a), from which states may choose to address these issues.

If the individual debtor has a driver's license issued by the state in which the individual has his or her principal residence, then under Alternative A—the "only if" rule—the driver's license is the source of the debtor's name for purposes of UCC-1.[26] (References to the driver's license in this analysis should be read to include an identification card, if such identification cards are issued by the same office as an alternative to a driver's license.) It does not matter what the individual's birth certificate says or what name he or she uses from day to day; all that matters is what is on the driver's license. It is essential to use exactly the words, letters, spaces and punctuation on the driver's license and not to expand or contract them, because this is the only correct name for purposes of the financing statement.

Only if the person does not have a driver's license, should the secured creditor then pursue one of the other options available in an Alternative A state. One is the person's surname and first personal name. The other option is simply the debtor's "individual name" (the post-2001 rule, explained in the commentary quoted above).

Alternative A may be the easier rule for searchers to employ, because if the debtor has a driver's license that has remained continuously outstanding for a long period of time, the search may safely be conducted in only that "name." This ease of searching, combined with the relative ease of completing a financing statement when the debtor has a driver's license, seems to be producing a trend among adopting states in favor of Alternative A.[27]

Alternative B – "Safe Harbor" Rule

Alternative B, the "safe harbor" rule, has also been adopted by a significant number of states. These states declare that the secured party is permitted to choose without preference among three name options: the driver's license (if any), the surname and first personal name, and the debtor's "name" (post-2001 rule) are equally valid options, although it may not be equally easy to accurately determine what they are. The driver's license is merely a *safe harbor*. Thus, under either option, the driver's license is one of the alternatives; it is simply the mandatory way to determine the name in a state that adopts Alternative A.

Surname and First Personal Name

It may still be difficult, whether due to cultural preference, official errors or differences in the way names are presented on the licenses of various states, to determine what is the surname and what is the first personal name (depending, for example, on whether one or the other is the word on the left, the middle or the right). As another new comment explains:

> A financing statement does not "provide the name of the individual which is indicated" on the debtor's driver's license unless the name it provides is the same as the name indicated on the license. This is the case even if the name indicated on the debtor's driver's license contains an error.
>
> > Example 1: Debtor, an individual whose principal residence is in Illinois, grants a security interest to SP in certain business equipment. SP files a financing statement with the Illinois filing office. The financing statement provides the name appearing on Debtor's Illinois driver's license, "Joseph Allan Jones." Regardless of which Alternative is in effect in Illinois, this filing would be sufficient under Illinois' Section 9-503(a), even if Debtor's correct middle name is Alan, not Allan.
> >
> > A filing against "Joseph A. Jones" or "Joseph Jones" would not "provide the name of the individual which is indicated" on the debtor's driver's license. However, these filings might be sufficient if Alternative A is in effect in Illinois and Jones has no current (i.e., unexpired) Illinois driver's license, or if Illinois has enacted Alternative B.
>
> Determining the name that should be provided on the financing statement must not be done mechanically. The order in which the components of an individual's name appear on a driver's license differs among the States. Had the debtor in Example 1 obtained a driver's license from a different State, the license might have indicated the name as "Jones Joseph Allan." Regardless of the order on the driver's license, the

***Article 9 Amendments** continues on p. 25*

[24] UCC § 9-503 Cmt. 2.d.
[25] UCC § 9-503 Cmt. 2.d.
[26] UCC § 9-503 Legislative Note 3.
[27] Source: Corporation Service Company, <http://csctransactionwatch.com/amendments> (last visited April 28, 2013).

Electronically Stored Information in the Bankruptcy Context

Susan M. Usatine, Esq.
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Many bankruptcy professionals acknowledge they are not particularly "e-savvy." Financial advisors, accountants, crisis managers, turnaround consultants and transactional bankruptcy attorneys view electronically stored information (ESI) and e-Discovery as synonyms rather than related concepts and mistake ESI as a bankruptcy litigator's problem. In fact, the perceived and artificial divide between "e-savvy" bankruptcy litigators and all other bankruptcy professionals is limiting and likely to occasion clients to incur unnecessary expenses and worse, affect the accuracy and value of pre-petition restructuring and turnaround advice.

Bankruptcy professionals that understand ESI, its preservation, identification, collection and review will be best equipped to provide accurate, cost effective and expeditious pre-petition advice and better positioned to assist counsel with e-Discovery obligations in the event a petition is ultimately filed. In addition, bankruptcy professionals who become "e-savvy" are also more likely to manage their own electronic communications and information systems in a manner that limits their cost and risk as parties to a dispute or as recipients of non-party subpoenas.

This article is divided into five sections:

Section I, "ESI and Businesses in 2013" provides the historical backdrop for the discussion.

Second II, "Adversary Proceedings are Just the Beginning" introduces the Interim Report on Electronic Discovery (ESI) Issues in Bankruptcy Cases prepared by the ABA Electronic Discovery (ESI) in Bankruptcy Working Group. Critically, these draft guidelines make clear that the potential/actual debtor's obligation to preserve ESI extends beyond adversary proceedings, contested and disputed matters and includes the filing of the bankruptcy petition itself.

Section III, "The Rules of Engagement" sets forth a general overview of the framework of rules that apply once the petition has been filed.

Section IV, "Proportionality in Bankruptcy" addresses how the proportionality doctrine can limit redundant or disproportionate discovery demands by permitting the Court to balance, *inter alia*, the nature and complexity of the dispute, importance of the issues at stake and the parties' resources.

Section V provides three key takeaways for bankruptcy professionals.

I. ESI and Businesses in 2013

Bankruptcy professionals who provided services and advice to potential and actual debtors during the 1990s recession appreciate how email and the internet have impacted how businesses conduct business. The Information Age, also known as the Computer Age or Digital Age, reached a turning point during the early 1990s with the advent of personal computing followed by the internet and the increase of national and international information flow. It is generally recognized that the dissemination of knowledge has played a major role in globalization.[1] Chief Information Officers, Chief Technology Officers and general counsels intuitively know that ESI's significance is staggering given its exponential and explosive growth. The founder of the Compliance, Governance and Oversight Counsel (CGOC) states:

> 90% of the data in the world today was created in the last two years, and data volumes are rising faster than storage prices are declining and technology is improving. A data growth rate of 40 percent can mean that 15 petabytes in 2011 will become 39 petabytes by the end of 2014. Even with a 20 percent decline in storage unit costs, the per petabyte cost of tier one storage for most large enterprises will likely range between $1.5 million and $5 million and will rise to consume close to 20 percent of the typical IT budget.[2]

The expansive universe of ESI requires bankruptcy professionals to understand the new information landscape and the pitfalls for the unwary.

II. Adversary Proceedings are Just the Beginning

The ABA Working Group on Electronic Discovery (ESI) Issues in Bankruptcy Cases is comprised of judges, former judges, and bankruptcy professionals.[3] The Working Group is currently studying the scope and timing of, *inter alia*, a debtor-in-possession's obligations with regard to ESI. It is critical that bankruptcy professionals are aware that the Working Group's Interim Report on Electronic Discovery in Bankruptcy and its draft guidelines consider the debtor-in-possession's obligations not only with regard to adversary proceedings, but also the bankruptcy case filing itself, and the obligations of non-debtor parties to preserve ESI in connection with adversary proceedings and contested matters in a bankruptcy case.

The Interim Report's draft guidelines are divided into three bankruptcy related subject areas: (1) large Chapter 11 cases, (2) middle market and smaller Chapter 11 cases, and (3) Chapter 7 and Chapter 13 cases. *See* Interim Report at 1. The Interim

[1] International Monetary Fund (2000), "Globalization: Threats or Opportunity" 12th April 2000 (corrected January 2002). The International Monetary Fund identified four basic aspects of globalization: trade and transactions, capital and investment movements, migration and movement of people and the dissemination of knowledge. http://www.imf.org/external/np/exr/ib/2000/041200to.htm

[2] "Defensible Disposal: You Can't Keep All Your Data Forever," Deidre Paknad, http://www.forbes.com/sites/ciocentral/2012/07/17/defensible-disposal-you-cant-keep-all-your-data-forever/.

[3] The Interim Report can be accessed at http://www.ediscoverylaw.com/uploads/file/Electronic%20Discovery%20Issues%20in%20Bankruptcy%20Cases.pdf. To date, the March 2012 draft guidelines have not been revised or reissued.

Report sets forth four core principles, the first of which is related to preservation, specifically, "The duty to preserve ESI and other evidence applies in the bankruptcy context." *See* Interim Report, Appendix at 1.

The report specifically states,

> A person or entity preparing to file a bankruptcy case should consider appropriate steps to preserve ESI and other evidence. In addition, potential debtors and non-debtor parties have an obligation to preserve ESI and other evidence related to the filing of a contested matter, adversary proceeding or disputed issue in a bankruptcy case. The duty to preserve may arise prior to the formal filing of the bankruptcy case or other litigated a matter, generally when the case filing or other potential litigation matter becomes reasonably anticipated. *Id.*

Although Principle 2 of the Interim Report specifically states that the actual or anticipated filing of a bankruptcy petition does *not* require a debtor to preserve *every* piece of information in its possession, it is often difficult from the outset to identify relevant ESI. Pre-petition, bankruptcy professionals are advised to gain an understanding of the client's electronic information systems, including the types of ESI the client maintains and the locations where it is used and stored. Bankruptcy professionals should review the business' data retention policy and suspend automatic deletion that may affect relevant ESI and identify data that are likely to be identified as not reasonably accessible.

Knowing the types of ESI and the sources of the client's ESI is of value to all bankruptcy professionals. Bankruptcy professionals who are ESI knowledgeable can deploy powerful technology to identify, collect, and analyze ESI within an organization. When the professional knows how to marshal and "data mine" the business' ESI, he/she is better equipped to quickly map a turnaround strategy. Similarly, bankruptcy professionals who are "e-savvy" can use open source "big data" to help analyze the business' growth markets, credit decisions and gain fresh and fast insights into the business' customers and future employees.

III. The Rules of Engagement

Bankruptcy professionals are positioned to be extremely helpful to bankruptcy litigation counsel in the days leading up to the filing of the bankruptcy petition and in the months that follow. The Federal Rules of Civil Procedure (FRCP) require counsel to expeditiously obtain knowledge regarding the client's ESI. Bankruptcy professionals who have prepared an ESI map (either formally or informally) will provide enormous value to their client and counsel by minimizing the likelihood of overlooked data and avoiding inefficiencies.

Counsel's obligations are significant and bankruptcy professionals should be generally familiar with the ESI "rules of engagement." For example, FRCP 26, incorporated in bankruptcy proceedings and matters under Bankruptcy Rule 7026 and 9014, directs that a party must, among other things, address the management, retention and disclosure of ESI early in a case. In addition, at the outset of an adversary proceeding (subject to certain exemptions or stipulations or order of the court), a party must voluntarily, and without awaiting a discovery request, provide the other parties with a description by category and location of all ESI, other than non-accessible ESI that the party has in its possession, custody or control and may use this information to support its claims or defenses. Fed. R. Civ. P. 26(a)(1)(A)(ii) (2008). Moreover, FRCP 26 requires that counsel become familiar with its client's information systems and develop a discovery plan that addresses ESI. Fed. R. Civ. P. 26(f)(3)(C)(2008). Bankruptcy professionals who have consulted with the client for months (or years) before the petition was contemplated will be assistive to the client (and counsel) in navigating these requirements.

Bankruptcy professionals should expect that bankruptcy counsel will seek their input regarding clients ESI resources, including the network, servers, clouds and/or other digital repositories and hardware, including desktop computers and portable devices. This information is routinely disclosed to the Court and adversaries and Judges have increasingly become intolerant of counsel who engage in ESI "cat and mouse" driven by counsel's lack of e-savvy, a desire to conceal the information, or both.

Bankruptcy professionals should be aware that there is a widely held view that adversaries should cooperate when it comes to ESI and e-Discovery issues. This stems in large part from a desire to control costs. Bankruptcy litigators increasingly are aware of The Sedona Conference (TSC) recommendations and guidelines. TSC is a nonprofit, 501(c)(3) research and educational institute dedicated to the advanced study of law and policy in the areas of antitrust law, complex litigation, and intellectual property rights and is a leading resource in the e-Discovery world. Bankruptcy professionals and counsel should review TSC's "Cooperation Proclamation."[4] The Cooperation Proclamation's recommendations are designed to control costs associated with adversarial conduct in pre-trial discovery, escalating motion practice, overreaching, obstruction, and extensive, but unproductive discovery disputes – in some cases precluding adjudication on the merits altogether – when parties treat the discovery process in an adversarial manner. The

4 The full report can be accessed here: https://thesedonaconference.org/cooperation-proclamation.

Cooperation Proclamation interprets the Federal Rules of Civil Procedure that pertain to e-Discovery as a mandate for counsel to act cooperatively and the proclamation cites case law in support of the judiciary's agreement with this principle.[5] Methods to accomplish this cooperation include:

1. Utilizing internal ESI discovery "point persons" to assist counsel in preparing requests and responses;
2. Exchanging information on relevant data sources, including those not being searched, or scheduling early disclosures on the topic of ESI;
3. Jointly developing automated search and retrieval methodologies to cull relevant information;
4. Promoting early identification of form or forms of production;
5. Developing case-long discovery budgets based on proportionality principles; and
6. Considering court-appointed experts, volunteer mediators, or formal ADR programs to resolve discovery disputes.

Counsel's failure to cooperate violates what TSC recognizes as lawyers twin duties of loyalty, specifically, acting as a zealous advocate for their clients while fulfilling the professional obligation to conduct discovery in a diligent and candid manner.[6]

IV. Proportionality in Bankruptcy Discovery

Principle 3 of the ABA's Interim Report references the three "Ps" of e-Discovery, specifically, proportionality, preservation and production. The report states, "[a] party's obligations with respect to the preservation and production of ESI should be proportional to the significance, financial and otherwise, of the matter in dispute and the need for production of ESI in the matter." Proportionality considerations are critical in the bankruptcy context as "[d]ebtors will be operating within constraints and generally have limited assets. Creditors often face the prospect of less than a full recovery, frequently a significantly reduced one, on claims against the bankrupt estate." *See* Interim Report, Appendix at 2. Bankruptcy professionals are well advised to consider at the outset of a case: (1) bankruptcy court approval of an interim ESI protocol addressing ESI issues including preservation efforts; (2) including in debtor's first day affidavit a description of the debtor's preservation practices made prior to the filing.[7]

TSC highlights six principles of the proportionality doctrine. Each is a potential tool for the bankruptcy professional and counsel looking to control the costs of e-Discovery:

1. The burdens and costs of preserving potentially relevant information should be weighed against the potential value and uniqueness of the information when determining the appropriate scope of preservation.
2. Discovery should generally be obtained from the most convenient, least burdensome and least expensive sources.
3. Undue burden, expense, or delay resulting from a party's action or inaction should be weighed against that party.
4. Extrinsic information and sampling may assist in the analysis of whether requested discovery is sufficiently important to warrant the potential burden or expense of its production.
5. Nonmonetary factors should be considered when evaluating the burdens and benefits of discovery.
6. Technologies to reduce cost and burden should be considered in the proportionality analysis.

V. Key Takeaways for the Bankruptcy Professionals

In the context of a potential bankruptcy, it is difficult to identify early in a case all of the information that will eventually prove to be relevant to a disputed or contested matter or adversary proceeding. It is common for a debtor, Trustee or committee to encounter an information system that is compromised, obsolete or fragmented. Defensible preservation, collection and review can be daunting and costs are always a consideration. With these challenges in mind, the following non-exhaustive list of key takeaways is proposed as considerations for the "e-savvy" bankruptcy professional:

1. **Consider a Pre-petition Preservation Plan**—The bankruptcy professional should take affirmative steps to safeguard ESI. Pre-filing, the potential/actual debtor's preservation plan should be reviewed and automatic deletion/culling of data should be suspended to protect potentially relevant and fragile ESI.
2. **View ESI as a Potential Asset/Liability of the Estate**—The bankruptcy professional's understanding of the business' ESI includes: knowing the what, where and who of ESI:
   - The "what" are the characteristics of the business' information system today and at the time the events in question occurred; the data retention policy and its effect on the ESI at issue; the software applications used by employees, the frequency of data back-ups, departing employee procedures and automatic delete/cull protocol.
   - The "where" is the professional's knowledge of the sources of ESI including on-line data storage on servers, off-line data storage on back-up and/or archive tape or similar media; desktop and portable computers at the workplace and beyond.

[5] *See, e.g.*, Board of Regents of University of Nebraska v BASF Corp. No. 4:04-CV-3356, 2007WL 3342423, at *5 (D. Neb. Nov. 5, 2007) ("The overriding theme of recent amendments to the discovery rules has been open and forthright sharing of information by all parties to a case with the aim of expediting case progress, minimizing burden and expense, and removing contentiousness as much as practicable. [citations omitted]. If counsel fails in this responsibility—willfully or not—these principles of an open discovery process are undermined, coextensively inhibiting the courts' ability to objectively resolve their clients' disputes and the credibility of its resolution.").

[6] Not surprisingly, the fourth and final principle the ABA Interim Report is, "[i]nterested parties in a bankruptcy case are encouraged to confer regarding issues related to the preservation and production of ESI." *See* Interim Report, Appendix at 2.

[7] *Rimkus Consulting Group, Inc. v. Cammarata*, 688 F. Supp. 2d 598, 613 (S.D. Tex. 2010) ("Whether preservation or discovery conduct is acceptable in a case depends on what is reasonable, and that in turn depends on whether what was done – or not done – was proportional to that case and consistent with clearly established applicable standards.")

- The "who" includes the Trustee, adversary, litigant, Court, committee, regulatory or taxing authorities etc. who have a current and/or future interest or potential/actual debtor, debtor-in-possession's ESI. The bankruptcy professional that has a strong grasp on the *what* and *where* of their client's ESI is best equipped to anticipate and answer the requests, investigations and/or claims of these potential interested parties.

3. **Accomplishing Efficiency—**Aside from cooperation in the e-Discovery process there are other efficiency measures that bankruptcy professionals should consider as financial advisors, consultants, accountants and similar bankruptcy professionals are frequent targets of non-party subpoenas seeking all relevant communications with the debtor. To streamline the response to these ever increasing and broad requests for ESI, bankruptcy professionals should:

    1) Practice ESI best practices in terms of creation of electronic communications. These basic tips include treating email communications as formal communications, choosing meaningful subject lines in the email and taking care not to forward attorney-client privileged email communication to third parties.

    2) Establish a reasonable and defensible document retention policy and ESI destruction ("defensible deletion") policy, as well as consolidating data in an email (or content) archiving solution for more effective management and faster access to the data. All ESI should undergo assessment: Is it subject to hold? Is it subject to compliance? Is it subject to neither? Does it have value?

    3) Bankruptcy professionals should establish a legal hold response team within their organization. Legal holds require that the recipient suspend routine destruction of responsive ESI and paper documents. In addition to emails, responsive ESI can include: Microsoft Word documents, Excel or similar spreadsheets/databases/ presentations, Outlook calendar appointments/notes/ tasks, digital voicemail messages, text and instant messages, digital faxes and e-newsletters, Outlook notes, social media posts, web pages and/or metadata stored on laptops/desktops/servers/vehicle computer systems, back-up tapes, on-line repositories/ "the Cloud," GPS devices, fax machines, home computers/personal email accounts, group shares, off-site storage, removable media (zip drives, flash drives), smart phones/other phones, tablets, social media (Twitter, Facebook, LinkedIn, blogs), CD, DVD, and copy machines/scanners/printers with hard drives among others.

Conclusion

ESI is not going away. While it may be tempting to minimize its likely impact or staying power, doing so simply defers the necessary learning curve. Bankruptcy professionals who embrace the ESI challenge will service clients at a higher level than those who remain comfortably e-unaware. As an added benefit, e-savvy bankruptcy professionals will improve their ESI economics by improving access to valuable ESI and reducing risk and e-Discovery costs.

Susan Usatine *is a member of the Cole, Schotz, Meisel, Forman & Leonard, P.A. (www.coleschotz.com) litigation department and is the founder and co-chair of the firm's Information Governance practice group and Discovery Services practice group (susatine@coleschotz.com). She represents domestic and international businesses in bet-the-company litigation in federal and state courts, mediation and arbitration proceedings. Ms. Usatine is regarded as a litigator who understands how the Information Age has indelibly altered the way businesses make strategic decisions including the handling of high-stakes disputes.*

Value of Net Operating Losses to the Bankruptcy Estate

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Introduction

The intersection of tax law and bankruptcy law has always been a somewhat esoteric field. This paper provides a brief overview of one subset of this intersection: the value of net operating losses (NOLs) to the bankruptcy estate. NOLs arise when the taxpayer's deductible business expenses exceed its net income for the year.[1] § 172(a) of the Tax Code allows for a deduction of current NOLs plus NOL carrybacks for such year.[2]

To illustrate the value of NOLs to the bankruptcy estate, this paper will discuss four cases in detail. The first two cases pertain to an irrevocable tax election under § 172(b). § 172(b) provides that once the taxpayer sustains NOLs, it may carry the loss back three years as a deduction in that year, resulting in a refund.[3] Alternatively, if the NOLs survive the three-year carryback period, they can be carried forward for a period of fifteen years beginning from the year the loss was incurred, until it is exhausted.[4] The irrevocable election under § 172(b) allows the taxpayer to forego the three year carryback period in lieu of the carry forward.[5]

The second set of two cases pertains to NOLs incurred by the debtor, but used by an entity other than the debtor. The first case will involve the use of NOL deductions to offset income by the parent and affiliated subsidiaries of the debtor through consolidated tax returns. The second case pertains to the use of NOLs by shareholders of the S-Corporation debtor.

All four cases will demonstrate the value of NOLs to the bankruptcy estate and the mechanisms used by the trustee/Committee to counter the deprivation of value from the estate. After a detailed discussion of these cases, this paper will analyze these mechanisms used by the trustee/Committee. The mechanisms can be broadly classified in two categories: claims under bankruptcy law, and claims under state law.

Prior to delving into the cases, it might be helpful to note the importance and value of tax attributes to the bankruptcy estate.

Value of Tax Attributes to the Bankruptcy Estate

The value of tax attributes to the bankruptcy estate is well documented in two seminal cases, one Bankruptcy Code provision, and one Tax Code provision.

Tax Code § 1398(g) provides that the estate will succeed to certain enumerated tax attributes such as NOLs. More subtly, Bankruptcy Code § 541(a)(1) - (a)(7) seems to include such tax attributes in the property of the estate as well.[6] Case law also leans towards the inclusion of tax attributes in the property of the estate. A pre-Bankruptcy Code U.S. Supreme Court case, *Segal v. Rochelle*, noted that the property of the estate should be viewed through the lens of the purpose of bankruptcy law, which is "to secure for creditors everything of value the bankrupt may possess in alienable or leviable form when he files his petition."[7] Twenty four years after the *Segal* decision, the Ninth Circuit in *In re Neuton* noted that the generous definition of property under *Segal* demonstrates that an economic right or benefit is "not outside its reach because it is novel or contingent or because enjoyment must be postponed."[8] Both cases demonstrate the expansive view of property utilized by the courts to include tax attributes in the bankruptcy estate.

In re Russell: Prepetition Claim

The *In re Russell* line of cases is possibly the most notorious involving the use of NOLs in a bankruptcy context. The taxpayer in *In re Russell* filed a voluntary bankruptcy petition on July 18, 1984.[9] The controversy revolved around two federal tax returns filed by the taxpayer: the first on August 12, 1983, and the second on October 10, 1984.[10] We shall discuss the first of the two federal tax returns (prepetition) in this section and the second tax return (postpetition) in the following section. On both occasions, the taxpayer irrevocably elected under Tax Code § 172(b) to carry forward the NOLs instead of receiving a refund of $1,205,536 from the carryback.[11] The trustee initially sought the option of amending the past returns but was denied because of failure to file within the prescribed statutory period.[12]

The trustee's second option was to petition the bankruptcy court to avoid the first 1983 election as a § 548 fraudulent transfer.[13] The Bankruptcy Court and the District Court for the Western District of Arkansas both ruled against the trustee on procedural grounds because of failure to properly raise the issues in the pleadings.[14] On appeal to the Eight Circuit Court of Appeals, the IRS chose to defend the case on its merits rather than on procedural grounds, allowing the court to address the threshold question: "whether a trustee's powers under the Bankruptcy Code can be used to invalidate a debtor's irrevocable election under the Tax Code."[15] The court of appeals held that the trustee should be allowed to avoid irrevocable elections, and remanded the case to the bankruptcy court to determine whether the

1 28 U.S.C. § 172 (2006).
2 *Id.*
3 *Id.*
4 *Id.*
5 *Id.*

6 McQueen, C. & Williams, J. (1997), *Tax Aspects of Bankruptcy Law and Practice* (pp. 6-24).
7 *Segal v. Rochelle*, 382 U.S. 375, 379 (1966).
8 *Neuton v. Danning* (*In re Neuton*), 922 F. 2d 1379, 1382 (9th Cir. 1990).
9 *Gibson v. United States* (*In re Russell*)¸ 1989 U.S. Dist. LEXIS 12937, 2 (D. Ark.1989) .
10 *Id.* at 3.
11 *Id.* at 2.
12 *Id.*
13 *Id.*
14 *Id.*
15 *Gibson v. United States* (*In re Russell*), 927 F.2d 413, 415 (8th Cir. 1991).

election was an avoidable fraudulent transfer under § 548 of the Bankruptcy Code.[16]

In answering the threshold question, the court first looked at the statutory intent behind the irrevocability of the § 172(b) election.[17] The court found the statutory intent for irrevocability to be the IRS's interest in requiring the taxpayer to assume the risk that a carryback period would prove preferable in hindsight.[18] As succinctly described in *United States v. Kapila* (to be discussed below), "the theory behind the irrevocable nature of a NOL carryback waiver is to prevent individuals from pushing in all their chips and then requesting them back when the dealer hits twenty one."[19] The court of appeals in *In re Russell* held that Congress' intent behind the irrevocability of the § 172(b) election was of no consequence to this case, because the facts did not involve a taxpayer's hindsight realization that the carryback period would be more beneficial than the carry forward period.[20] Instead the case directly implicated the purpose underlying a trustee's avoidance powers because it involved a trustee trying to avoid the election in order to preserve the bankruptcy estate.[21] The court continued that if the taxpayer was allowed to make the election without the safeguard of the trustee's avoidance powers, the taxpayer/ debtor could easily deprive the unsecured creditors of value while avoiding future tax liability by simply making the election in anticipation of bankruptcy.[22] Such a result would be contrary to the extraordinary powers granted to the trustee to avoid certain transfers in the interest of protecting the bankruptcy estate.[23]

Finally, the court addressed the IRS's argument that the Bankruptcy and Tax Codes do not allow the trustee to alter the tax attributes of the bankruptcy estate.[24] The IRS specifically pointed to Tax Code § 1398(g)(1), which provides that the bankruptcy estate succeeds to the NOLs existing at the beginning of year bankruptcy case commences.[25] Accordingly, the IRS argued that this provision should prevent the trustee from avoiding the prepetition election because the NOLs had already passed to the bankruptcy estate as carried forward.[26] The court responded by finding that the IRS's argument does not apply because the trustee was challenging the election, and not the current status of the NOLs.[27] Additionally, the court emphasized that their holding is not contrary to the Tax Code's provision for the irrevocability of the election because the court's decision will not allow the trustee to revoke the election, but only to avoid it.[28] The practical effect of such avoidance would be such that the taxpayer never made the election to begin with.[29]

The dissenting opinion for the court of appeals argued that the NOL election was not subject to the trustee's avoidance powers because of the express language of Tax Code § 1398(g)(1), and Congress' intent demonstrated in the drafting of the same provision.[30] Section 1398 was drafted four years after § 172, and if Congress wanted to allow a trustee to avoid the irrevocable elections under § 172, they would have provided for such in the drafting of § 1398.[31]

On remand, the bankruptcy court held that the election did not constitute actual fraud under Bankruptcy Code § 548(a)(1) because the debtor relied on the advice of his C.P.A. in making the election.[32] Such reasonable reliance on professional advice made in good faith shielded the election from avoidance as an actually fraudulent transfer.[33] The bankruptcy court refused to address the issue of constructive fraud for procedural reasons. On appeal, the district court remanded the constructive fraud issue to the bankruptcy court for further review as it rejected the procedural reasons for refusal to address the issue.[34]

The bankruptcy court considering the issue of constructive fraud determined that the election was avoidable under § 548(a)(2) because the debtor was insolvent at the time of the election and did not receive reasonably equivalent value for the transfer.[35] The court based its decision on the opinion of the trustee's expert, whom they found to be more credible than the IRS's expert.[36] This issue was appealed to the district court, which affirmed the bankruptcy court's decision, deferring to its judgment on the credibility of the witnesses.[37]

In re Russell: Postpetition Claims

The postpetition claims in *In re Russell* arise from the October 10, 1984 tax returns, which made the same election as the prepetition election to forego the carryback refund. In order to avoid the 1984 election, the trustee shifted the court's focus from Bankruptcy Code § 548 prepetition avoidance to § 549 avoidance of postpetition transactions.

The IRS argued to bar the suit for failure to file within the two-year statutory period prescribed by the Bankruptcy Code § 549.[38, 39] The Eight Circuit Court of Appeals rejected this argument, stating that the suit was not a Bankruptcy Code § 549 proceeding but a refund suit under Tax Code § 1346(a)(1), and that the trustee's complaint complied with the statutory period prescribed in the Tax Code for refund suits.[40] The court then discussed the four elements of § 549, stating that the claim satisfied the first three elements:[41] (1) that the action was taken after the

16 *Gibson v. United States* (*In re Russell*), 927 F.2d 413, 415 (8th Cir. 1991).
17 *Id.* at 416.
18 *Id.*
19 *Kapila v. United States*, 386 B.R. 361, 371 (D. Fla. 2008).
20 *In re Russell*, 927 F.2d 413, 415 (8th Cir. 1991).
21 *Id.*
22 *Id.*
23 *Id.*
24 *Id.* at 418.
25 *Id.*
26 *Id.*
27 *Id.*
28 *Id.*
29 *Id.*

30 *Id.*
31 *Id.*
32 *In re Russell*, 154 B.R. 723, 726 (Bankr. Ark. 1993).
33 *Id.*
34 *In re Russell*, 187 B.R. 287, 290 (D. Ark. 1995).
35 *Id.* at 291.
36 *Id.*
37 *Id.*
38 Bankruptcy Code § 549 allows the trustee to avoid an unauthorized postpetition transfer of property.
39 *In re Russell*, 927 F.2d 413 at 417.
40 *Id.*
41 *Id.*

commencement of the bankruptcy case;[42] (2) that the property of the bankruptcy estate was involved—the property being the right to carry forward NOLs;[43] and (3) that the property was transferred—the irrevocable election constituting a disposition of the right of the bankruptcy estate to carry forward the NOLs.[44] The fourth element was remanded by the court of appeals to the bankruptcy court, to determine whether the election was made in the ordinary course of business.[45]

On remand, the bankruptcy court utilized a two-pronged test and held that the election was made in the ordinary course of business.[46] The first prong, the horizontal dimension test, compares the debtor's actions to the actions of similarly situated businesses.[47] The second prong, the vertical dimension or the creditor expectation test, looks to whether the action was within the reasonable expectation of the interested parties.[48] The court held that, absent a showing of bad faith or fraud, both prongs will be categorically satisfied in the case of a tax election.[49]

The district court affirmed the bankruptcy court's decision on appeal finding that the opinion was not clearly erroneous.[50] As stated in the previous section, the district court remanded the issue of prepetition constructive fraud to the bankruptcy court, where the bankruptcy court found that the prepetition election was constructively fraudulent.[51] The IRS then appealed this prepetition finding to district court, and the trustee followed suit by appealing the previously affirmed bankruptcy court judgment on the postpetition claims.[52]

The district court affirmed the bankruptcy court on the issue of prepetition constructive fraud but reversed it on the issue of postpetition ordinary course of business.[53] The latest finding by the bankruptcy court that the prepetition election constituted constructive fraud affected the district court's opinion on the postpetition election as it stated, "[i]f Russell's tax election was constructively fraudulent in 1982, it is inconceivable that the same election was made in the ordinary course of business in 1983."[54] The court also noted that the postpetition election clearly violated the vertical dimensions test as it was not within the reasonable expectations of the creditors.[55]

United States v. Kapila

In *United States v. Kapila* the bankruptcy court of the Southern District of Florida was presented with the sole issue of whether a § 172(b)(3)(C) election constituted constructive fraud in a chapter 7 context.[56] Unlike *In re Russell*, the court did not have to decide on the threshold question of whether the trustee could avoid an irrevocable tax election. The debtor/taxpayer was the sole shareholder of two S-Corps.[57] The business failure of the S-Corps resulted in a NOL of $ 58,612 in 2005 for which the debtor elected to forego the carryback period under Tax Code § 172(b)(3)(C) on July 24, 2006.[58] The debtor filed a voluntary chapter 7 petition within six months of filing the tax returns.[59] The trustee argued that the election should be avoided, allowing the estate to receive a $ 11,201 refund from the year 2003, because it constituted constructive fraud under Bankruptcy Code § 548(a)(2).[60] The bankruptcy court granted summary judgment to the trustee.[61]

In order to prove the election was a constructive fraudulent transfer, "the trustee must prove that the debtor (a) within two years, (b) had interest in property, (c) transferred it, (d) and received less than reasonably equivalent value for that transfer, and (e) was insolvent on the date of that transfer."[62] The court found that requirements (a) and (e) were satisfied as the election was made within two years of filing the petition and the debtor was insolvent when he made the election.[63]

In its analysis of whether the debtor had an interest in the property, the court held that the relevant "interest in property" is the pre-transfer NOL carryback tax attribute.[64] The court relied on the seminal Supreme Court case, *Segal v. Rochelle* (discussed above), which held that the right to receive a tax refund constituted an interest in property.[65] The bankruptcy court held that since a right to receive a tax refund constituted an interest in property, an election to waive the carryback period and forego the right to a present refund should also constitute an interest in property.[66] Also the mere fact that the election is irrevocable under the Tax Code did not alter its nature as an interest in property.[67]

As for requirement (c) regarding the transfer of the interest of property, the court noted that the waiver represented the debtor trading his right to the IRS, which resulted in the IRS no longer needing to pay the present refund.[68] Consequently, the waiver of the present refund operated as the transfer as a matter of law.[69]

Finally, the court held that requirement (d) was also satisfied because the debtor did not receive reasonably equivalent value for the election.[70] According to the court the debtor's election to waive a substantial refund was more certain and greater in value than a speculative future tax attribute.[71] The "future contingent

Value of NOLs *continues on p. 27*

42 *Id.* at 418.
43 *Id.*
44 *Id.*
45 *Id.* at 419.
46 *In re Russell*, 154 B.R. 723, 728 (1993).
47 *Id.*
48 *Id.*
49 *Id.*
50 *In re Russell*, 189 B.R. 190, 194 (D. Ark. 1994).
51 *Id.*
52 *In re Russell*, 187 B.R. 287 at 290.
53 *Id.* at 292.
54 *Id.*
55 *Id.*
56 *Kapila v. United States*, 386 B.R. 361 (D. Fla. 2008).
57 *Id.*
58 *Id.* at 362.
59 *Id.*
60 *Id.*
61 *Id.*
62 *Id.* at 368.
63 *Id.*
64 *Id.*
65 *Id.*
66 *Id.*
67 *Id.*
68 *Id.* at 369.
69 *Id.*
70 *Id.* at 370.
71 *Id.*

ZOLFO COOPER - RANDY WAITS AWARDS

Gold, Silver and Bronze Medals were presented by Robert Bingham, CIRA, of Zolfo Cooper, at the Annual Awards Banquet, Thursday June 8. Sponsored by Zolfo Cooper, the awards recognize candidates who earned the top composite scores for all three parts of the CIRA exam completed by the end of the previous calendar year.

Gold Medalist—Scott Tandberg, CIRA, is a Vice President in the Turnaround and Restructuring Group at AlixPartners and lives in Colorado. Prior to AlixPartners, he was a Portfolio Analyst for Highland Capital Management in Dallas, Texas and was also a Senior Associate for PwC in New York. Scott earned a Masters of Accounting degree from Brigham Young University. He is an avid skier, climber, biker and runner, which explains why he lives in Colorado. Scott speaks fluent Portuguese and spent 2 years in Brazil for his church.

Silver Medalist—Briana Richards, CIRA, has a Bachelor of Commerce degree from Queen's University in Kingston, Ontario, Canada. She left her Ernst & Young Vice President position in Canada to become a Senior Manager for Ernst & Young in New York. Briana began her restructuring career with Ernst & Young's Canadian restructuring practice and in 2008 she moved to New York to assist with building out the US presence. She currently lives in Manhattan with her husband, Rim, and enjoys exploring the city and new restaurants; skiing, golf, and home renovations.

Bronze Medalist—Spencer Ferrero, CIRA, received his CIRA certification on July 25, 2012 and is a Senior Associate with Berkeley Research Group in Los Angeles. He has a Masters of Accounting degree from the University of Utah. Spencer was unable to attend the conference as his wife was due to deliver their baby. Jamison Gary Ferrero was born on 6/15/13; mother and son are doing well. Congratulations again to Spencer!

Certificates were presented to (from left): **Briana Richards**, **James Gomez**, **Todd Plugge**, **Michael Scannella**, **Peter Heinz**, **Charles Braley**, **Neil Minihane**, **Scott Tandberg**, and **Vorachai ("Ricky") Tejapaibul** (all CIRAs); and **Robert Cronin** (CDBV).

CERTIFICATES OF DISTINGUISHED PERFORMANCE

Some candidates achieve composite scores on the CIRA exam that are only a point (or a few points) below the top three. Therefore, the Distinguished Performance Awards were created to recognize outstanding achievement of scorers who were just short of receiving medals. Recipients who were present at the Annual Conference were **Peter Heinz**, FTI Consulting, Dallas, Texas; and **Neil Minihane**, CIRA, Turn Works LLC, Colorado Springs, Colorado.

Not present at the conference: **Chris Brown, CIRA**, Navigant Capital Advisors, Evanston, Illinois; **Tanner MacDiarmid, CIRA**, Alvarez & Marsal, LLC, San Francisco, California; **Kyle Nelson**, AlixPartners, LLP, Dallas, Texas; **Cari Turner**, Alvarez & Marsal, LLC, Dallas, Texas.

National Hockey League Bankruptcies

Forrest Lewis, CPA

Bankruptcies among franchises in the four major league sports in the United States have been fairly rare in the last twenty years. While there have been many franchises in financial trouble, usually the league has been able to broker a sale before a bankruptcy petition has actually been filed—however, there have been three in the National Hockey League and two in Major League Baseball. Of these, all have resulted in sales of the teams and apparently none have involved losses to unsecured third party creditors as is common in bankruptcy. This article will cover the three NHL bankruptcies and a future article will cover the two MLB bankruptcies.

Sports bankruptcies present several unique aspects—usually there is a league franchise agreement, which purports to give the league power over a financially troubled franchise including veto power over prospective buyers, and there is a distinctive relationship with the home city. Typically there is a very expensive stadium and high emotional fan and civic attachment to the team, much more so than encountered in the potential sale and relocation of other types of businesses. As often portrayed in the *Seinfeld* television series, everyone in town feels they have a say in running the city's major sports teams. Historically stadiums were privately owned by the franchise owners, but during the last 30 years the trend has been for the municipality to facilitate team finances by building the stadium and providing a long term lease to the team. On the other hand, those same long term leases create huge executory contracts in a bankruptcy scenario. Indeed, the feeling of "ownership" by the citizenry often has a basis in fact.

Professional Hockey in the United States

Professional hockey has struggled in the United States ever since the 1967 expansion from the original six teams. In terms of league revenues, hockey is the poor cousin of the other three major professional sports (2010-2011 data, in billions)[1]:

National Football League	$ 11.0
Major League Baseball	$ 7.0
National Basketball Association	$ 4.3
National Hockey League	$ 3.3

Bear in mind that a NHL team has a roster of 23 players, is played on a refrigerated ice surface which is expensive to maintain, and the league has a footprint stretching from Florida to Montreal to Vancouver to California. Presumably the NHL has higher average, non-salary operating costs than the NBA which has 12-man active rosters and arenas which are more adaptable to multiple uses. Hockey's TV ratings are lower than the other three major pro sports, its Nielsen ratings averaging under 2.0. Although most of the Canadian franchises draw well, many in the US struggle. In addition, the NHL's frequent labor problems have not helped: there was a strike in 1992 and a lock out in 2005 each of which lost an entire season, plus there were shortened seasons in 1994, 2011 and 2012.[2]

1995 Los Angeles Kings

The Kings were one of the 1967 NHL expansion teams, originally owned by Jack Kent Cooke (Cooke was a former owner of the Washington Redskins and the Los Angeles Lakers, and the builder of the Forum near Los Angeles). In 1979, the late Dr. Jerry Buss purchased both the Kings and the Lakers from Cooke. Buss later sold the Kings to Bruce McNall who made his initial fortune as a coin collector and in the 1980s produced several Hollywood movies, including *The Manhattan Project* and *Weekend at Bernie's*. After McNall became the controlling shareholder of the Kings in 1987, he went on a spending spree which started with acquiring the NHL's biggest star, Wayne Gretzky, along with Marty McSorley and Mike Krushelnyski. The Gretzky move to California from Edmonton, in particular, caused a huge furor in Canada.[3] McNall raised Gretzky's annual salary from less than $1 million to $3 million, which in turn triggered a dramatic rise in NHL salaries throughout the 1990s.[4]

In 1992, McNall was elected chairman of the NHL Board of Governors—the league's second-highest post—and reportedly played a key role in the hiring of Commissioner Gary Bettman. McNall's aggressive spending helped propel the Kings to the Stanley Cup Finals in 1992-93, under first year Head Coach Barry Melrose, where they lost to the Montreal Canadiens. (Melrose, who had played in Winnipeg, Toronto and Detroit, is now a TV hockey analyst.)

In December 1993, McNall defaulted on a $90 million loan and Bank of America threatened to force the Kings into bankruptcy unless he sold the team. He was also under investigation for bank fraud in connection with other defaulted bank loans. In May 1994, McNall sold his controlling interest in the Kings and resigned as chairman of the NHL board of governors. He was ultimately convicted of defrauding multiple banks of more than $200 million and eventually served nearly five years in prison.[5]

In the meantime the Kings changed ownership twice. McNall sold the team to Joseph Cohen and Jeffrey Sudikoff in 1994, before current owners Philip Anschutz and Ed Roski purchased the team from the executives for $113 million and kept it in Los Angeles. On the day of the second sale, Cohen and Sudikoff allowed

[1] Article: Major professional sports leagues in the United States and Canada. From Wikipedia, the free encyclopedia.

[2] Article: National Hockey League. From Wikipedia, the free encyclopedia.

[3] Gretzky had married American actress Janet Jones on July 17, 1988 in a wedding costing over $1 million which was dubbed the "royal wedding" and was televised across Canada. Public perception was that part of Gretzky's motivation in accepting the move to Los Angeles was to further Jones' acting career. Much of the criticism in Canada was focused on Jones. Article: Wayne Gretzky. From Wikipedia, the free encyclopedia.

[4] Article: Bruce McNall. From Wikipedia, the free encyclopedia.

[5] Los Angeles Times, June 28, 2011.

the team to file for bankruptcy so that the sale could proceed, presumably to obtain the benefits of a speedy Bankruptcy Code Section 363 sale and the clear title that goes with it.[6] The sale closed approximately five minutes before the Monday, May 16, 1994 hearing on the appointment of an interim trustee, which if ordered would have delayed, if not stopped, the sale. Under the sale agreement, the buyer assumed all of the team's hockey-related obligations including substantial deferred compensation owed Wayne Gretzky, $8.4 million owed to the NHL, player contracts, arena contracts, television contracts and bank loans. Notably, the NHL Constitution was assumed by the buyer with the express consent of the NHL.[7]

Thus, the Kings bankruptcy was a fairly "sanitary" affair and did not raise some of the issues that arose in later sports bankruptcies; i.e., the League's authority over a financially troubled franchise, veto power over prospective owners, and the ability of either the League or the buyer to move the team to another city.

1998 Pittsburgh Penguins

The Pittsburgh Penguins were also a 1967 expansion franchise. The initial investors included H. J. Heinz Company heir H. J. Heinz III, Pittsburgh Steelers owner Art Rooney, and the Mellon family's Richard Mellon Scaife. Though the Penguins had won Stanley Cup Championships in 1991 and 1992 behind Hall of Fame player, Mario Lemieux, their success tailed off in later years. Lemieux, who had battled cancer, retired in 1998. The Penguins' struggles on the ice led to similar off-ice struggles: at one point average attendance dropped below 15,000 per game and they owed over $90 million to various creditors. Payroll had spiraled upwards during the 1990s from $9 million to $34 million.[8] Owners Howard Baldwin and Morris Belzberg (who bought the Penguins from Edward DeBartolo after their first Cup win) asked the players to defer their salaries to help pay the bills. Mario Lemieux's deferred compensation of $31 million made him one of the biggest creditors.[9] When the deferred salaries finally came due combined with other financial pressures, the Penguins' ownership entity Pittsburgh Hockey Associates was forced to file for chapter 11 bankruptcy in November 1998.[10] For much of the 1998–99 season it looked like the Penguins would either move or fold.

In the bankruptcy proceedings the NHL took a firm position that its Constitution prohibits a transfer of a member of the league or any of its ownership interests except pursuant to its transfer approval procedure. Gary Bettman, the NHL's commissioner, was quoted as saying he would be strongly opposed to the Penguins declaring bankruptcy. "He cited the NHL Constitution, which states that an owner 'risks forfeiture' of a franchise that goes through bankruptcy, and said he would exercise his authority to take over the franchise."[11] Another problem was the stadium which was one of the oldest in the NHL. The Pittsburgh Auditorium Authority, which had built and owned the stadium, forcefully moved for and obtained at one point an eight year injunction against the team being moved.[12] Later the bankruptcy court ruled that the lease could be rejected.[13]

The court received at least three feelers from interested buyers: one led by an affiliate of the former debtor, Spectacor Management Group of Pittsburgh, and the local Fox Sports TV affiliate that owned the local TV rights; one from the NHL, presumably involving relocation; and one from a group to be put together by Mario Lemieux. Not surprisingly the court accepted the bid of the Lemieux group in a June 24, 1999 ruling, presumably because of local support and the "soft money" credit bid of Lemieux's $31 million deferred compensation receivable. Supposedly the Lemieux bid was hatched in October of 1998 between Lemieux and his advisers over dinner at a Pittsburgh steakhouse. Bored with playing golf since his retirement, Lemieux was looking to get back into hockey in a more active way. Lemieux managed to interest Beverly Hills billionaire Ronald Burkle in investing $20 million in the purchase. Reportedly Lemieux met with Burkle over breakfast in the Atlanta airport while Burkle was on his way from London to California.[14] They are still listed as co-owners of the team on the Penguins official website.

Lemieux came back out of retirement and played for the team from 2000 to 2006. According to newspaper reports, in 2007 Lemieux apparently agreed to a redemption of his interest stemming from his unpaid deferred compensation for $21 million.[15] Led by superstars Sidney Crosby and Evgeni Malkin, the team went on to win the 2009 Stanley Cup. In 2010 a new stadium, Consol Energy Center, was built funded by casinos to be located nearby and team and public monies.[16]

Again, because many issues were compromised in the agreement of sale, few legal issues were formally decided. The litigation concerning the stadium lease set confusing precedents as an injunction against movement was initially issued but in the end the court ruled the lease could be rejected.

2009 Phoenix Coyotes

In 1996 the Winnipeg Jets were relocated to the Phoenix, Arizona, area and renamed the Coyotes. In 2001 a majority interest in the team was acquired by real estate developer Steve Ellman and a minority interest was acquired by retired hockey superstar Wayne Gretzky, who became head of hockey operations. The team moved their venue in 2003 from downtown Phoenix where they shared an arena with the Phoenix Suns to Jobing.com Arena, which the suburban city of Glendale had built at a cost of $183 million. In 2005 Ellman sold his interest to Jerry Moyes, a part owner of the Arizona Diamondbacks baseball team, but Gretzky retained his interest and remained with the Coyotes. In December 2008

NHL Bankruptcies *continues on p. 30*

6 LAK Acquisition.

7 Wynne, Wald and Loo. (1999). Sports franchises and bankruptcy. ABI paper, p. 5.

8 Washington Post.com, October 7, 1999.

9 Wynne, Wald and Loo, p.6.

10 In re Pittsburgh Sports Associates Holding Company, Pittsburgh Hockey Associates, HBRM, LLC, Debtors. Bankruptcy Nos. 98-28174BM to 98-28176BM. United States Bankruptcy Court, W.D. Pennsylvania. October 13, 1998.

11 Wynne, Wald and Loo, p.7.

12 Timeline: How Pens went from bankruptcy to champs. NHL-NBC Sports.com.

13 In re Pittsburgh Sports Associates Holding Company, Pittsburgh Hockey Associates, HBRM, LLC, Debtors. Bankruptcy Nos. 98-28174BM to 98-28176BM. United States Bankruptcy Court, W.D. Pennsylvania. June 18, 1999.

14 Washington Post.com, Thursday, October 7, 1999.

15 ESPN.com. October 19, 2007.

16 Consol Energy Center. From Wikipedia, the free encyclopedia.

Bankruptcy Taxes

The following article was written by:

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MANAGING CLAIMS TO MAXIMIZE TAX

On February 8, 2013, the IRS released Private Letter Ruling 201306003 responding to a taxpayer's request for ruling as to whether its plan of reorganization met the requirements of IRC § 382(l)(5)[1]. While the names, dates and dollar amounts have been changed to protect the innocent, we can conclude that either the debtor's facts or the tax law was sufficiently complex to warrant the not insignificant expense of requesting a PLR. Clearly, tax attributes take on an importance in bankruptcy that they may not have had in the loss years that a debtor frequently has leading up to chapter 11 and creditors have a vested interest in protecting them. The operation of IRC § 382 in a Title 11 case is a critical issue and opportunity that debtors and their advisors must address when planning for troubled companies. While it has likely been covered in past issues of *AIRA Journal*, the topic is so important that it warrants a refresher.

Most readers will be familiar with the basic tenets of IRC § 382. IRC § 382 sets forth limitations on the net operating loss ("NOL") carryforwards and certain built-in losses that a corporation can use following an ownership change. The limitation is tied to the value of the loss company's stock immediately *before* an ownership change.

First promulgated by Congress in 1954, IRC § 382 underwent a number of modifications until it was rewritten in 1986. While earlier iterations sought to reduce or eliminate the NOLs being carried over, the modern version limits the amount of NOLs that can be used to reduce income in post-change years, but does not reduce or eliminate the actual NOLs (except in certain circumstances). The rules are generally divided into two parts—determining when an ownership change has occurred and calculating the actual limitation. Both parts are highly arithmetical but with many tedious rules to affect the formulas.

While IRC § 382 is mechanically difficult to calculate and apply, it is conceptually simple: it operates by imposing a limitation on the future use of tax losses when there is a change in ownership. Frequently in a bankruptcy setting, the creditors are in "control" of the company under the jurisdiction of the Court. So if under a debtor's Plan, creditors receive more than 50 percent of the stock of emerged company, there has technically been an ownership change—but has there really been a change in control? Recognizing that bankruptcy presents unique issues under IRC § 382, Congress included (l)(5) and (l)(6) to provide further guidance. Treasury Regulation § 1.382-9 amplifies these two subparagraphs.

When an ownership change occurs in a Title 11 bankruptcy or similar case (e.g., receivership, foreclosure or similar proceeding under a Federal or state court), (l)(5) or (l)(6) govern how much NOLs carry forward and to what limitation those NOLs are subject.

IRC § 382 (l)(5)

In an insolvency setting, equity shareholder interests frequently take a back-seat to creditor interests. In a bankruptcy setting, while creditors may not formally own the equity of debtor entity until after the debtor's formal emergence, the creditors effectively control the company during bankruptcy. Under a "normal" application of IRC § 382, a debtor would likely emerge with very little or no ability to use its historical NOLs (because its equity value immediately prior to emergence is generally very low or zero). A low equity value prior to emergence and a low IRC § 382 limitation would further reduce a creditor's ability to recover some of its debt investment that funded a debtor's NOLs. Fortunately, (l)(5) (and in a different manner, (l)(6)) provides relief from the normal IRC § 382 rules.

For bankrupt (Title 11 or similar cases) companies undergoing an ownership change, if at least 50 percent of the emerged company is owned by shareholders who were either shareholders or creditors of the company immediately before the ownership change, then the limitations of IRC § 382 do not apply. The emerging company has no limit on the future deduction or use of its NOL carryforwards and credits. This fantastic exception comes with some very big adjustments and restrictions.

First, only creditors that were ordinary course creditors at least 18 months prior to filing chapter 11 are considered. For cases where there is substantial buying and selling of claims, this first restriction may be difficult to manage. For debtors and principal creditors wanting to emerge under (l)(5), this restriction can cause anxiety and require addition procedures and controls.

Second, if another IRC § 382 ownership change occurs within two years after emergence, the IRC § 382 limitation on the second ownership change is zero, meaning no NOL carryforward will be allowed. If creditors who evolve to shareholders hope to liquidate their equity investment as soon as possible after emergence, (l)(5) may not be a good choice.

Third, carrying the theory that former creditors were in control prior to the ownership change, (l)(5) requires the debtor to reduce its NOLs and credit carryforwards by the amount of interest paid on debt owed to creditors who become post-emergence shareholders. The add back is required for any indebtedness converted to equity and includes the interest accrued or paid for the three complete tax years preceding ownership change and the year of the ownership change. Effectively, this provision adjusts the NOLs as if these former creditors were really former equity shareholders.

IRC § 382 (l)(6)

For debtors that are not eligible for the (l)(5) exception, IRC § 382 still presents a significant problem. If the limitation on the post-change use of NOLs and credits is calculated based on the equity

[1] For purposes of this article, we will refer to IRC § 382(l)(5) as "(l)(5)" and IRC § 382(l)(6) as "(l)(6)".

value of the company immediately before emergence, presumably when the equity value is depressed with debt, there would be little hope for using those NOLs. Since not all companies qualify under (l)(5), Congress promulgated (l)(6). IRC § 382 (l)(6) is available to chapter 11 filers who are ineligible for or elect out of (l)(5). The equity value of the old company is adjusted upward for the debts being cancelled in the bankruptcy. So effectively, the IRC § 382 limitation is calculated under (l)(6) based on the "reorganized" equity value. Treasury Regulation § 1.382-9 (j) clarifies that the value of the loss corporation for companies qualifying under (l)(6) is the lesser of the equity value of the company immediately after reorganization or the asset value immediately before reorganization.

Which One Is Better?

IRC §§ 382 (l)(5) and (l)(6) provide relief to the normal limitations on the future use of NOLs and credits following an ownership change. Determining which is better is a complicated exercise that debtors and their advisors should begin addressing well prior to finalizing the Plan. Much of the benefit of one provision over the other will depend on the facts of the case. For example, some debtors have very low NOLs or have NOLs for which interest expense is a very small component. For these debtors, the NOL reduction (interest add back) provisions of (l)(5) are not an obstacle. In other cases, post-change equity holders may be planning to divest their investment as soon as possible, therefore the two-year prohibition on subsequent ownership changes under (l)(5) may be restricting. If NOLs are going to be substantially reduced by the interest add back, then asset basis will receive a larger reduction under the attribute reduction rules of IRC §§ 108 and 1017—modeling may be utilized to compare timing of the use of NOLs with an IRC § 382 limitation versus lost depreciation deductions. Likely, the analysis of whether (l)(5) or (l)(6) is more favorable involves an iterative process with evolving assumptions in a dialogue between debtor management, its attorneys and its tax accountants.

Note that if a debtor meets the qualifications of (l)(5), then that is the default treatment. However, a debtor may elect out of (l)(5) by including a statement with its timely filed return. If, after modeling, a taxpayer definitively concludes it does not want to use the (l)(5) exception, it is prudent to elect out on its tax return even if the taxpayer believes it is ineligible for (l)(5). The election involves a simple form in the return and may help avoid a future IRC § 9100 relief filing for a late election.

Who's in Control Anyway?

For debtors who preliminarily conclude that (l)(5) provides a more beneficial avenue for emergence, creditor activity during bankruptcy becomes extremely relevant. Trading in claims could effectively take away the availability of (l)(5) by eliminating sufficient qualified creditors to reach the 50-percent equity ownership requirement upon emergence. Therefore, debtors frequently seek to limit any trading or transactions that creditors can effect on their claims. Private Letter Ruling 201306003, which prompted this article, provides details whereby the debtor, under the Court's supervision, instituted a plan to limit creditor transactions so that it could preserve its ability to qualify for the (l)(5) exception upon emergence. The debtor's plan required creditors owning more than some de minimis percentage of debt to notify the Court of their holdings and to obtain permission prior to any transactions involving that debt.

It Is Better to Conclude Than to Assume

The preservation of NOL and credit carryforwards takes on a heightened importance in bankruptcy. Fortunately, IRC § 382, which generally limits the post-emergence use of NOLs, provides several exceptions and opportunities favorable to taxpayers in chapter 11. The rules related to these exceptions are tedious to apply and will be influenced greatly by the facts of the case. A thorough analysis and dialogue between the debtor, attorneys, valuation experts and accountants is advisable. While Plans and Disclosures frequently speak to the mechanics of (l)(5) and (l)(6), there is little substitute for actually modeling out the assumptions and potential scenarios. So work with the other advisors and conclude—don't assume.

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ALTERNATIVES FOR TAX TREATMENT OF DISPUTED CLAIMS RESERVES

Forrest Lewis, CPA
Section Editor

The tax treatment of disputed claims reserves in connection with bankruptcy liquidations is unsettled and somewhat mysterious. The theory behind the existence of the disputed claims reserve is sound; usually at the time of the confirmation of the bankruptcy plan the claims reconciliation process in a big case has not had time to sort out all filed claims and definitively allow or disallow them, plus time for the objection process for disallowed claims. In some cases many duplicate or spurious claims may be filed. Thus a case often proceeds to confirmation without the amount of all allowable claims being known, which is the reason for creation of a disputed claims reserve at confirmation in some cases. This article will discuss the possible tax treatments of a disputed claims reserve in the typical case where a plan provides for a "disputed claims reserve" to be created in connection with a liquidating trust which qualifies under Internal Revenue Service Revenue Procedure 94-45. Obviously, this decision needs to be made at the time the tax provisions of the Plan and the Disclosure Statement are written which determines how the reserve will be treated for tax purposes by the liquidating trustee and their tax preparer.

Amazingly, the entire regime of tax rules in connection with bankruptcy liquidations has come about just since the late 1980s. Following the major US Supreme Court decision in Holywell, which finally ruled that liquidating bankruptcy trusts did need to file tax returns, the Internal Revenue Service implemented some fairly workable rules in Revenue Procedure 94-45. Basically that procedure creates a safe harbor type of trust which has the following characteristics:

It is passive and short term, i.e. cannot be intended to carry on *business activities indefinitely.*

It creates a fictional transaction in which assets to be ultimately distributed to the allowed claimholders are transferred from the debtor to the claimholders upon the effective date, but then immediately re-transferred by them to *the l*iquidating trust, making the creditor now a beneficiary of the trust.

The liquidating *trust is* treated as a "grantor" trust for tax purposes, meaning the annual income or expense of the trust is passed through to the claimholder/beneficiary. Further, any items affecting basis such as cash distributions and gains and losses pass directly through to the creditor/beneficiary. Thus, it is an aggregation of the interests of the underlying creditor/beneficiaries.

While Rev. Proc. 94-45 does not require a liquidating trust to employ a "disputed claims reserve", it does say if one exists that "all the income must be taxed." Presumably the IRS would also say in the case of an annual loss, they do not want all the deductions allocated only to the allowed claims, some must be allocated to the disputed claims reserve. The dilemma that arises when you have disputed claimants is that you have income that isn't taxed at the trust level but which the trustee may not want to allocate to allowed claimants. Thereby you get into a conundrum that some trustees solve with a disputed claims reserve. .

Digression on the Practical Aspects of Liquidating Distributions

From a financial point of view, the disputed claims reserve brings an element of flexibility to the system. From a tax point of view it is just another complication in an area where theory does not fit with reality. The theory of determining liquidating distributions is that at the Plan effective date you know the dollar sum of all classes of claims and the fair market value of all estate assets. Then you can simply divide a given creditor's claim by the total of claims and then multiply that by the fair market value of assets available to that class. Many plans require that each creditor be notified of the value of their interest in the liquidating trust at formation. In truth, the amount of valid claims and value of assets are moving targets which evolve, usually over a period of years. The value of some assets, especially foreign investments and legal causes of action, can take years to establish. Establishing the disputed claims reserve involves the process of carving out at the Plan effective date the amount of disputed claims which will ultimately be allowed and is just another difficult estimation.

Possible Tax Treatments of Disputed Claims Reserve

In the last thirty years, the use of liquidating trusts has greatly increased, presumably because creditors' committees are not comfortable leaving the assets under control of the debtor entity and want them set aside into a new entity with new administrators and being more subject to the control of the creditors. Assuming that a given plan is going to create a liquidating trust conforming to Rev. Proc. 94-45 and provides for establishing a "disputed claims reserve," what are the various arrangements and their tax treatment that can be written into the Plan? Collier on Bankruptcy Taxation, Ch. 14, has an excellent discussion of the alternative treatments of the disputed claims reserve. They say there are four possible alternatives (paraphrased):

(1)The arrangement could be taxed similarly to a grantor trust of the debtor;

(2) The arrangement could be taxed as if it were a grantor trust established by the creditors to resolve their conflicting claims to the plan consideration;

(3) The arrangement could be taxed as a complex trust; or,

(4) The arrangement could be treated as a "disputed ownership fund" under the 2006 regulations creating "disputed ownership funds under Internal Revenue Code Section 468B.

Evaluation of the Alternatives

Since the first two alternatives are rather theoretical and rarely seen in practice, they will be discussed only briefly:

Grantor trust of the debtor—Collier concludes this is not appropriate since the debtor rarely has a substantial interest in the assets in the disputed claims reserve. It runs contrary to the intent of moving the assets out of the debtor entity and in pure liquidation cases, the debtor is often soon dissolved, so there would be no grantor to recognize the income or loss of the trust.

Grantor trust of the creditors—The concept of allocating the income or loss due to the disputed claims to the allowed claims or to all claimholders is illogical and impractical. The idea of allocating the income of the disputed claims to the allowed claims runs directly contrary to the reason that the disputed claims reserve is established—in order to segregate the known from the unknown. Also, in a big case with hundreds or thousands of creditors, filing a grantor trust requires the annual issuance of a grantor letter to each creditor, most of them with very small amounts of income or loss.

Complex trust—About ten years ago, most disputed claims reserve were established as complex trusts in Plan documents. From a practical point of view, the complex trust is still a decent alternative. Usually the complex trust is set up as one of the creditor/beneficiaries of the main liquidating trust and so gets a share of the annual income or loss of the liquidating trust. Typically, annual liquidating operations will generate a tax loss and a disputed claims reserve set up as a complex trust will simply record its share of the loss. No K-1 forms have to be issued to the creditors with disputed claims and the loss deductions can be carried forward or back in case of the realization of taxable income in some years. The major disadvantage of the complex trust is high tax rates, 39.6% beginning at about $12,000 of taxable income. Another practical problem is that for any accumulated net operating loss that still exists when liquidating distributions are completed and the trust terminates, the trust may not have any beneficiaries to allocate the loss to. Even though there may be some apparently "unused" net operating loss, in fact, when the liquidation process ends, creditor/beneficiaries are entitled to write off any remaining tax basis in their interest. Thus, the creditors will always ultimately recognize any loss to which they are entitled

Disputed ownership fund under Reg. 1.468B-9— Originally, Internal Revenue Code Section 468B was enacted to allow a corporation an immediate tax deduction for transferring in trust monies to fund legal judgments or settlements which would be paid out over time in personal injury cases, utility rate suits, etc. Since then, the Congress and the IRS have expanded the purview of the section to a wider array of situations. In 2006, the Internal Revenue Service finalized Reg. 1.468B-9 on the use of "disputed ownership funds" for bankruptcy disputed claims reserves. Unless the Plan of Reorganization specifies a different tax treatment for the disputed claims reserve, e.g. a complex trust, the regulation permits the trustee to make an election to treat this portion of the liquidating trust as a Disputed Ownership Fund. This election must be timely made by the filing date, including extensions of the initial liquidating trust tax return (generally 3/15 of the year after the effective date, if not extended, or 9/15 if extended).

Taxation of a Disputed Ownership Fund

Generally, a disputed ownership fund is taxed under the C corporation regime but subject to an important distinction based on the nature of the assets in the liquidating trust. In the typical situation where a liquidating trust receives, in addition to cash, real estate, legal causes of action, furniture and equipment or other business assets to liquidate, the disputed ownership fund will file Form 1120 and be treated as a normal C corporation. It will enjoy the usual 15%, 25% and 35% tax brackets and the ability to carry a net operating loss forward and back. Also, no K-1 forms are required to be issued to the beneficiaries. *This is probably the best vehicle for a disputed claims reserve holding the type of assets listed above.*

On the other hand, a disputed ownership fund in a very "clean" liquidating trust holding only cash, interest bearing obligations and perhaps stock in a few subsidiaries that are going to be sold in a stock sale is treated as a passive disputed ownership fund subject to the Qualified Settlement Fund rules. Such fact situations are fairly rare. This type of disputed ownership fund files Form 1120-SF. While no K-1 forms are required to be issued by this entity, one big disadvantage of the QSF rules is that allowable deductions are limited to administrative expenses of the fund. Other common types of bankruptcy proceeding expenses are not deductible. The other major disadvantage is that there is a flat 39.6% tax rate. In this rare situation, a complex trust might be a better choice because while it also has the 39.6% tax rate, it does not have the limitation on the type of deductible expenses.

Commentary

In most cases, a plan of reorganization in which a disputed claims reserve is desired should be written to create a disputed ownership fund under Reg. 1.468B-9. The trustee should then make the required election and direct that Form 1120 be filed. That will probably result in the lowest tax rate and most flexibility for net operating loss carryforward/back, i.e. the least likely to actually incur any net federal income tax at the disputed claims reserve level. In the rare case where a disputed claims reserve and its related liquidating trust hold only cash and stocks, a careful choice should be made between Qualified Settlement Fund treatment and complex trust treatment.

Thanks to Joshua Elliott, Grant Newton and Dennis Bean for their assistance with this article.

COURT FINALLY DETERMINES FORMULA FOR DEMUTUALIZED STOCK BASIS

One long standing position of the Internal Revenue Service which has rankled tax practitioners is the insistence by IRS that when an insurance company demutualizes, the insureds who receive the new corporate stock have no basis in the stock. Taxpayers and their representatives have been chipping away at that position for years and finally a federal district court has approved one taxpayer's formula for establishing that there is tax basis.[2]

Mutual insurance companies historically treated their insureds as the equity holders of the company. The equity of the company was purely earnings retained from net income. In recent years, many of them have "demutualized" or converted to a stock insurance company, usually in order to more easily access capital. The Dorrance case involved a large trust owning policies from five different mutual companies including Prudential, Metlife, Phoenix Home Life, etc. Generally a demutualization involves issuing stock to the insureds in proportion to the size of premiums paid and the transaction is treated as an Internal Revenue Code Section 368 recapitalization. Thus, the issuance of stock to the insured is tax free and incurs no tax at the insurance company level. However, despite the thousands of dollars the insured may have paid to the insurer from which the mutual's equity was carved out, the Internal Revenue Service has consistently taken the position that the insured has no tax basis in the shares of stock received. Many insureds immediately sell the stock which they view as a windfall and according to IRS, recognize a taxable gain in the amount of the sales proceeds. Taxpayers and their advisers have long offered various theories establishing basis but have had rather limited success in litigation against the IRS.

The attorneys in the Dorrance case founded their basis calculation on the method used by the insurance companies to issue the shares as explained in the ruling:

"When determining how many shares of stock to give policyholders, the Companies calculated (1) a fixed component for the loss of voting rights, since each policyholder was entitled to one vote, and (2) a variable component for the loss of other rights, measured by the policyholder's past and projected future contributions to the company's surplus. Of the variable component, 60% was an estimate of each policyholder's past contributions to surplus as of the calculation date while the remaining 40% was an estimate of future contributions."

"However, projected future contributions to surplus are a portion of premiums which Plaintiffs had not actually paid before receiving shares and cannot be considered as a part of basis….. Therefore, Plaintiffs' basis is equal to the combination of the IPO value of shares allocated to Plaintiffs for (1) the fixed component representing compensation for relinquished voting rights ("fixed shares") and (2) 60% of the variable component representing past contributions to surplus ("variable shares")."

[2] Dorrance v. US, U.S. District Court, D. Arizona; CV-09-1284-PHX-GMS, March 19, 2013.

The court held that the taxpayers had a tax basis of about $1 million in the shares which they sold for $1.8 million. The Internal Revenue Service is continuing to litigate the issue but seems to be slowly losing the battle.

Thanks to Grant Newton and Dennis Bean for their assistance with this article.

MORE ON IRS "FRESH START INITIATIVE" FOR TAX DEBTORS

The Internal Revenue Service recently instructed the Collections Division on how to proceed under the new IRS "Fresh Start Initiative" for tax debtors. Generally the order raises the dollar amount a taxpayer may owe the IRS before a tax lien is filed on the taxpayer's property from $5,000 to $10,000 in some, but not all, cases [SBSE-05-0313-014 issued March 26, 2013]. The memorandum is worded in terms of when a Revenue Officer *should issue* a Notice of Federal Tax Lien, so in cases where the tax liability is below the filing threshold, an adviser may be able to contest filing of any lien posted contrary to the memorandum.

Revenue Officers are to file a tax lien in the following cases:

In Chapter 11 and 12 cases where the taxpayer owes over $10,000 when the case has been dismissed, presumably because of lack of follow-through by the debtor

In Chapter 12 (farm) cases of individuals when there is a "postpetition" balance over $10,000, where the plan has been confirmed and the postpetition liability has not been made part of the plan, presumably not being discharged as part of the Plan. The memorandum says "There is no provision for filing claims for postpetition taxes of an individual debtor in a Chapter 12 case. One situation in which the individual debtor may incur postpetition tax liability is when there is a postpetition sale or other disposition of farm assets used in the debtor's farming operation. When the debtor is an individual, taxes arising from a postpetition sale of assets must be paid when they become due, and should not be provided for in the plan."

In Chapter 11 cases of entities other than individuals where there is a postconfirmation liability with an unpaid balance assessment of more than $10,000.

For single-member disregarded limited liability companies, if an LLC files for bankruptcy, but the single member is not in bankruptcy, a notice of federal tax lien should be filed against the single member where the member's unpaid balance assessment is over $10,000. This requirement will generally apply to employment tax liabilities incurred for periods prior to January 1, 2009, and to excise tax liabilities incurred for periods prior to January 1, 2008, where the single member is liable for such tax liabilities of the LLC. ■

Bankruptcy Cases

Prof. Baxter Dunaway
Section Editor

NINTH CIRCUIT

Can an unstayed judgment stop an involuntary bankruptcy?

This case presents a question of first impression in the Ninth Circuit: Under § 303(b)(1) of the Bankruptcy Code, 11 U.S.C. § 303(b)(1), is an unstayed state judgment on appeal *per se* a "claim against [the debtor] that is not contingent as to liability or the subject of a bona fide dispute as to liability or amount?" A two-judge 9th Circuit majority ruled that a non-default state court judgment that has not been stayed during an appeal fits that description. Therefore, the 9th Circuit's answer to that question is "yes." *Marciano v. Chapnick et al. (In re Marciano)*, 708 F.3d 1123, No. 11-60070, 2013 WL703157 (9th Cir. Feb. 27, 2013). The decision is contrary to 4th Circuit in *Platinum Financial Services Corp. v. Byrd (In re Byrd)*, 357 F.3d 433,438 (4th Cir. 2004).

Under § 303(b)(1), an involuntary bankruptcy may be commenced against a debtor by the filing of a petition by three or more entities, each of which is either a holder of a claim against such person that is not contingent as to liability *or the subject of a bona fide dispute as to liability or amount*, or an indenture trustee representing such a holder, if such noncontingent, undisputed claims aggregate at least $14,425 more than the value of any lien on property of the debtor securing such claims held by the holders of such claims. 11 U.S.C. § 303(b)(1) (fn. omitted).

Perhaps because the Bankruptcy Code does not define "bona fide dispute," interpretation of § 303(b)(1) has divided courts.[1] The majority view—the " *Drexler* " rule—is that unstayed non-default state judgments on appeal are not subject to bona fide dispute for purposes of § 303(b)(1).[2] Cases following this approach reason that it would be "contrary to the basic principles respecting, and would effect a radical alteration of, the long-standing enforceability of unstayed final judgments to hold that the pendency of the debtor's appeal created a 'bona fide dispute.' " *In re AMC Investors,* 406 B.R. at 484 (quoting *In re Drexler,* 56 B.R. at 967).

The minority approach—the " *Byrd* " rule—holds that, although "it will be the unusual case in which a bona fide dispute exists in the face of claims reduced to state court judgments[,] [s]uch judgments do not guarantee the lack of a bona fide dispute." *Platinum Fin. Servs. Corp. v. Byrd (In re Byrd),* 357 F.3d 433, 438 (4th Cir.2004). Under the *Byrd* rule, the petitioning creditor makes a "prima facie" case of compliance with § 303(b)(1) by presenting an unstayed state judgment, but the debtor is given the

[1] 2013 WL 703157, *1125.

[2] *In re Drexler,* 56 B.R. 960, 967 (Bankr.S.D.N.Y.1986); *accord In re AMC Investors, LLC,* 406 B.R. 478, 487 (Bankr.D.Del.2009); *Norris v. Johnson (In re Norris),* 1997 WL 256808, at *5, 114 F.3d 1182 (5th Cir.1997); *In re Euro–Am. Lodging Corp.,* 357 B.R. 700, 712 (Bankr.S.D.N.Y.2007) (per curiam) (unpublished); *In re Amanat,* 321 B.R. 30, 37 (Bankr.S.D.N.Y.2005); *In re Raymark Indus., Inc.,* 99 B.R. 298, 300 (Bankr.E.D.Pa.1989); *In re Caucus Distribs., Inc.,* 83 B.R. 921, 929 (Bankr.E.D.Va.1988).

opportunity nonetheless to demonstrate the existence of a bona fide dispute as to liability or the amount of the debt.[3]

With appropriate deference to the sister circuit, the Ninth Circuit concluded that the *Drexler* rule is correct as a matter of both statutory interpretation and federalism.[4]

BANKRUPTCY S.D.N.Y.

Assured/Flagstar case is the first of 'mortgage-putback' cases brought by financial guarantors against mortgage originators to go to trial.

Background: Flagstar Bank, a federally chartered savings bank located primarily in Michigan, provides residential mortgage loan origination services to its customers, including the origination of home equity lines of credit (HELOCs) and second-lien mortgages. Assured is a financial guaranty insurance company that provides bond insurance for, among other things, residential mortgage backed securities ("RMBS"). Trial Tr. 39:6–12. Financial guarantee insurer brought action against issuer of securities backed by home equity loans, alleging that underlying loans were either materially fraudulent or product of material underwriting defects and seeking reimbursement for its payment of insurance claims after many of loans defaulted. *Holdings*: Following a bench trial, the District Court, Jed S. Rakof, J., held that:

(1) expert's random sampling of loans from securitization pools was admissible; Expert's random sampling of loans from securitization pools to determine whether each loan conformed to representations and warranties made by issuer of securities backed by home equity loans in its agreements with financial guarantee insurer was admissible in insurer's action alleging that underlying loans were materially fraudulent and seeking reimbursement for its payment of insurance claims after many of loans defaulted; samples were representative of kind of loan characteristics used by insurer's damages expert, and they were designed to determine whether any loans breached issuer's representations and warranties in a way that was material and adverse to insurer. Assured Guar. Mun. Corp. v. Flagstar Bank, FSB, 2013 WL 440114, *26 (S.D.N.Y. Feb 05, 2013); (2) expert's testimony that loans breached representations and warranties made by issuer was admissible; (3) issuer breached its contractual obligation to repurchase materially defective loans; (4) insurer could recover $89.2 million plus interest in damages for issuer's breach; and (5) issuer was required to reimburse insurer for its costs and expenses in bringing action. Ordered accordingly. Assured Guar. Mun. Corp. v. Flagstar Bank, FSB, 2013 WL 440114 (S.D.N.Y. Feb 05, 2013) (NO. 11 CIV. 2375 JSR).

Comments on the case:

Phil Gusman, Moody's: "Bond Insurers May Benefit from Assured/Flagstar MBS Court Decision." 2013 WLNR 3464389, 2/11/13 PropertyCasualty360.com. ("The Assured/Flagstar case is the first of the 'mortgage-putback' cases brought by financial guarantors against mortgage originators to go to trial," say James Eck, vice president and senior credit officer of Moody's, and David Fanger.) ("For the financial guarantors, the stakes are high," Moody's continues. "As of third-quarter 2012, Assured had recorded $774 million of future mortgage loan putback recoveries...while MBIA Insurance Corporation...had recorded $3.2 billion. For capital-constrained guarantors such as MBIA, the ability to win trial verdicts and reach settlements with banks will have a meaningful effect on their policyholders and creditors.")

TENTH CIRCUIT, FOURTH CIRCUIT

Does BAPCPA Repeal the Absolute Priority Rule with Respect to Individual Chapter 11 Debtors?

This appeal presents an issue of first impression in the Tenth Circuit: whether the 2005 amendments to the Bankruptcy Code exempt individual Chapter 11 debtors from the absolute priority rule ("APR"). The bankruptcy court answered this question in the affirmative. It therefore confirmed the Debtors' proposed plan of reorganization over certain creditors' objections that the plan violated the absolute priority rule. On appeal, the bankruptcy appellate panel certified the case for direct appeal. Exercising the court's jurisdiction under 28 U.S.C. §§ 158(d)(2)(A) and 158(a)(1), the court of appeals reversed the bankruptcy court's order confirming the plan and remanded for further proceedings. In re Stephens, 704 F.3d 1279, 57 Bankr.Ct.Dec. 125, Bankr. L. Rep. P 82,366 (10th Cir.(Okla.) Jan 15, 2013) (NO. 11-6309).

Section 1129 of the Code sets out the general requirements for confirmation of a reorganization plan. Section 1129(a) allows for confirmation where each class of creditors consents. Alternatively, § 1129(b) provides a "cram-down" mechanism, whereby a plan may be confirmed without the consent of each class if, among other things, the plan is "fair and equitable." Section 1129 outlines the "fair and equitable" criteria, which include the absolute priority rule. Specifically, § 1129(b)(2)(B)(ii), as amended by BAPCPA, provides that:

> the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property, *except that in a case in which the debtor is an individual, the debtor may retain property included in the estate under section 1115,* subject to the requirements of subsection (a)(14) of this section.
>
> (emphasis added)

Section 1115, which BAPCPA added, in turn states:

> (a) *In a case in which the debtor is an individual, property of the estate includes, in addition to the property specified in section 541*[5]

[3] *Id.* at 439; *accord In re Tucker,* No. 5:09–bk–914, 2010 WL 4823917, at *3 (Bankr.N.D.W.Va. Nov. 22, 2010); *In re Briggs,* Nos. 07–34534, 07–34533, 2008 WL 190463, at *2 (Bankr.N.D.Tex. Jan. 18, 2008).

[4] 2013 WL 703157, *1127.

[5] Section 541 defines property of the estate to include "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541. Section 103, in turn, provides that § 541 applies in Chapter 11 cases, including those which involve individual debtors. *See* 11 U.S.C. § 103(a).

(1) all property of the kind specified in section 541 that the debtor acquires after the commencement of the case but before the case is closed, dismissed, or controverted to a case under chapter 7, 12, or 13, whichever occurs first; and

(2) earnings from services performed by the debtor after the commencement of the case but before the case is closed, dismissed, or converted to a case under chapter 7, 12, or 13, whichever occurs first.

(b) Except as provided in section 1104 or a confirmed plan or order confirming a plan, the debtor shall remain in possession of all property of the estate.

(emphasis added)

Although a number of courts have held this language to be unambiguous, they have reached starkly different conclusions regarding the "plain" meaning. *Compare SPCP Grp., LLC v. Biggins,* 465 B.R. 316, 322 (M.D.Fla.2011) ("The plain reading of this statute" is that § 1115 "includes ... property specified in section 541."), *with In re Steedley,* No. 09–50654, 2010 WL 3528599, at *2 (Bankr.S.D.Ga. Aug. 27, 2010) ("Nothing in the plain language of § 1115 suggests that it subsumes § 541."). The very existence of this dichotomy seems indicative of the text's ambiguity. Indeed, several courts have recognized that §§ 1115 and 1129(b)(2)(B)(ii) are susceptible to two different yet plausible interpretations. *See, e.g., In re Maharaj,* 681 F.3d 558, 569 (4th Cir.2012); *In re Lindsey,* 453 B.R. 886, 903 (Bankr.E.D.Tenn.2011).

To date, the Bankruptcy Appellate Panel for the Ninth Circuit and five bankruptcy courts (one of which was affirmed by a district court) have adopted a "broad view," holding that the BAPCPA amendments eliminate the APR as applied to an individual's *entire* estate.[6] In contrast, the Fourth Circuit and seventeen bankruptcy courts have reached the opposite conclusion, holding that the BAPCPA amendments only exempt from the APR that property which § 1115 *adds* to an individual estate—not the pre-petition property already defined by § 541.[7]

According to the broad view, § 1115 incorporates and supercedes § 541. Under § 1115, an individual's estate includes post-petition property and earnings in addition to the pre-petition property established by § 541. *In re Tegeder,* 369 B.R. 477, 480 (Bankr.D.Neb.2007); *see also In re Shat,* 424 B.R. 854, 863 (Bankr.D.Nev.2010) ("Initially, Section 1115 creates a baseline estate of all the property covered by Section 541. It then adds to that [post-petition property]."). When § 1129(b)(2)(B)(ii) references the property "included by" § 1115, it "refer[s] to all property Section 1115 itself references." *In re Shat,* 424 B.R. at 863. Section 1115 thus absorbs § 541 for individual Chapter 11 cases. *Id.* at 865. Therefore, the APR no longer applies to *any* property of an individual debtor's estate.

In contrast, the narrow view holds that § 1115 merely adds to—but does not replace— § 541's definition of estate property for individual debtors. *See, e.g., In re Draiman,* 450 B.R. 777, 821 (Bankr.N.D.Ill.2011). Section 1115 "includes" in the estate only that property which was not already included by § 541. *See In re Gbadebo,* 431 B.R. 222, 229 (Bankr.N.D.Cal.2010). In other words, § 1115 includes only post-petition property and earnings. *In re Draiman,* 450 B.R. at 821. In support of the narrow view, several courts have pointed to § 1115's grammatical structure. *See, e.g., In re Arnold,* 471 B.R. 578, 602 (Bankr.C.D.Cal.2012) (explaining that because the phrase, "in addition to the property specified in section 541" is "not the direct object of the transitive verb, 'includes,' " the phrase therefore "is not an answer to the question what is included as 'property of the estate' under § 1115"). Accordingly, only post-petition property added by § 1115 is exempt from the APR; the APR continues to apply to § 541's pre-petition property.

After examining the divergent interpretations of the statutory language, the Tenth Circuit agreed with the Fourth Circuit that "either construction is plausible." *In re Maharaj,* 681 F.3d at 569. In light of this linguistic ambiguity, the court endeavored to ascertain Congress's intent. *See United States v. Hohri,* 482 U.S. 64, 69–71, 107 S.Ct. 2246, 96 L.Ed.2d 51 (1987).

Is there a clear Congressional intent to repeal the absolute priority rule as applied to individual Chapter 11 debtors?

Nowhere in BAPCPA's sparse legislative history is there an explanation of what changes result from § 1115. *See In re Lindsey,* 453 B.R. at 903; Bruce A. Markell, *The Sub Rosa Subchapter: Individual Debtors in Chapter 11 After BAPCPA,* 2007 U. Ill. L.Rev. 67, 90. Consequently, courts have reached opposite conclusions regarding the legislative objective. *Compare In re Shat,* 424 B.R. at 862–65, *with In re Gbadebo,* 431 B.R. at 229–30. In deciphering Congress's intent, the court recognized BAPCPA's aim of curbing the abusive practices of unscrupulous debtors, *see* H.R.Rep. No. 109–31, pt. 1, at 3–5 (2005), *reprinted in* 2005 U.S.C.C.A.N. 88, 90–92, but the Tenth Circuit remained mindful that "a central purpose of the Code" is to provide the honest but unfortunate debtor with a "fresh start," *Grogan v. Garner,* 498 U.S. 279, 286–87, 111 S.Ct. 654, 112 L.Ed.2d 755 (1991) (quotations and citation omitted). This inherent tension makes it difficult to identify a singular objective behind § 1115. Advocates of the broad view emphasize that the BAPCPA amendments evince an intent to model Chapter 11 on Chapter 13, which has no absolute priority rule. *See In re Friedman,* 466 B.R. at 483; *In re Shat,* 424 B.R. at 868. In support, they cite a number of provisions that are essentially copied from Chapter 13. *See, e.g., In re Roedemeier,* 374 B.R. 264, 275–76 (Bankr.D.Kan.2007). Further, proponents of the broad view emphasize that abolishing the APR with respect to individual debtors does not leave unsecured creditors without any power or protection. Instead, unsecured creditors can rely on the safeguards of § 1129(a)(15)'s disposable income test, *see In re Shat,* 424 B.R. at 863–64, and § 1129(a)(7)'s "best interests" test.

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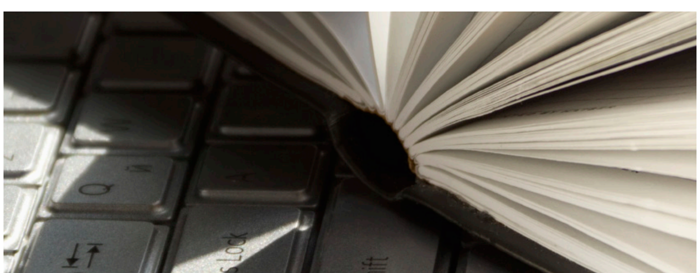
6 *In re Friedman,* 466 B.R. 471 (9th Cir. BAP 2012); *SPCP Grp., LLC v. Biggins,* 465 B.R. 316 (M.D.Fla.2011) (affirming unpublished decision of bankruptcy court); *In re Shat,* 424 B.R. 854 (Bankr.D.Nev.2010); *In re Johnson,* 402 B.R. 851 (Bankr.N.D.Ind.2009); *In re Roedemeier,* 374 B.R. 264 (Bankr.D.Kan.2007); *In re Tegeder,* 369 B.R. 477 (Bankr.D.Neb.2007).

7 *In re Maharaj,* 681 F.3d 558 (4th Cir.2012) (affirming the bankruptcy court's decision in 449 B.R. 484 (Bankr.E.D.Va.2011)); *In re Lee Min Ho Chen,* No. 11–08170 BKT, 2012 WL 5463256 (Bankr.D.P.R. Nov. 9, 2012); *In re Tucker,* 479 B.R. 873 (Bankr.D.Or.2012); *In re Arnold,* 471 B.R. 578 (Bankr.C.D.Cal.2012); *In re Lively,* 467 B.R. 884 (Bankr.S.D.Tex.2012); *In re Borton,* No. 09–00196–TLM, 2011 WL 5439285 (Bankr.D.Idaho Nov. 9, 2011); *In re Lindsey,* 453 B.R. 886 (Bankr.E.D.Tenn.2011); *In re Kamell,* 451 B.R. 505 (Bankr.C.D.Cal.2011); *In re Draiman,* 450 B.R. 777 (Bankr.N.D.Ill.2011); *In re Walsh,* 447 B.R. 45 (Bankr.D.Mass.2011); *In re Stephens,* 445 B.R. 816 (Bankr.S.D.Tex.2011); *In re Karlovich,* 456 B.R. 677 (Bankr.S.D.Cal.2010); *In re Gelin,* 437 B.R. 435 (Bankr.M.D.Fla.2010); *In re Steedley,* No. 09–50654, 2010 WL 3528599 (Bankr.S.D.Ga. Aug. 27, 2010); *In re Mullins,* 435 B.R. 352 (Bankr.W.D.Va.2010); *In re Gbadebo,* 431 B.R. 222 (Bankr.N.D.Cal.2010); *see also In re Friedman,* 466 B.R. at 476 (discussing the bankruptcy court's determination—in an unpublished February 17, 2011 order—that the APR applies to individual Chapter 11 debtors).

In contrast, those ascribing to the narrow view argue that, "[e]ach one of these new provisions," even where modeled on Chapter 13, "appears designed to impose *greater* burdens on individual chapter 11 debtor's rights so as to ensure a greater payout to creditors." *In re Gbadebo,* 431 B.R. at 229 (emphasis added); *see also* H.R.Rep. No. 109–31, pt. 1, at 2–5, 80–81. Narrow view proponents urge that if Congress intended to abolish the APR with respect to individual debtors, "it would have done so in a far less convoluted way." *In re Maharaj,* 681 F.3d at 565–66. For instance, Congress could have raised Chapter 13's debt ceiling or expressly exempted individual debtors at the beginning of § 1129(b)(2)(B)(ii). *See In re Karlovich,* 456 B.R. 677, 682 (Bankr.S.D.Cal.2010). Moreover, BAPCPA's legislative history lists several debtor protections but makes no mention of eliminating the APR. *See* H.R.Rep. No. 109–31, pt. 1, at 2, 17–18. Advocates for the narrow view argue that, had Congress intended such a drastic change, it surely would have included the amendment in its list of debtor protections. *See In re Maharaj,* 681 F.3d at 572. Instead, the amendments are best understood as preserving the status quo. *See, e.g., id.* at 569–70 (noting that the exemption of post-petition property and earnings ensures that the APR operates as it did prior to BAPCPA's passage).

Because both the statutory language and Congress's intent are ambiguous, the Tenth Circuit heeded the presumption against implied repeal. "[R]epeals by implication are not favored and will not be presumed unless the intention of the legislature to repeal is clear and manifest." *Nat'l Ass'n of Home Builders v. Defenders of Wildlife,* 551 U.S. 644, 662, 127 S.Ct. 2518, 168 L.Ed.2d 467 (2007) (quotations omitted). Where a party contends "that legislative action changed settled law," that party "has the burden of showing that the legislature intended such a change." *Green v. Bock Laundry Mach. Co.,* 490 U.S. 504, 521, 109 S.Ct. 1981, 104 L.Ed.2d 557 (1989). These interpretive principles are particularly critical in bankruptcy cases, where parties rely on settled rules in conducting and structuring business. Thus, "[p]re-BAPCPA bankruptcy practice is telling because the court will not read the Bankruptcy Code to erode past bankruptcy practice absent a clear indication that Congress intended such a departure." *Hamilton v. Lanning,* ––U.S. –––, 130 S.Ct. 2464, 2473, 177 L.Ed.2d 23 (2010) (quotation omitted). The court declined to find an implied repeal here.

The court therefore reversed the bankruptcy court's order confirming the plan and remanded for further proceedings.



After BAPCPA, may "Chapter 20" debtors strip off valueless home mortgages?

A recent law review considers whether after the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"),[8] valueless Chapter 13 liens may be stripped-off in a no-discharge Chapter 20 case.[9] Two recent cases in the Ninth Circuit, *In re Okosisi*,[10] and *In re Victorio*,[11] affirmed on appeal by District Court Judge Anello, illustrate the two approaches to lien retention of valueless liens for Chapter 13 debtors ineligible for discharge. *Okosisi* recognizes such lien strips, whereas *Victorio* does not These two decisions have in turn spawned a deluge of conflicting decisions in recent years. [12]

FIRST CIRCUIT BANKRUPTCY APPELLATE PANEL

First Circuit BAP holds that a trustee's use of strong-arm powers to avoid a mortgage lien and to preserve it for the benefit of the bankruptcy estate does not implicate *Stern v. Marshall,* –– U.S. –––, 131 S.Ct. 2594, 180 L.Ed.2d 475 (2011). In re Traverse, 485 B.R. 815 (1st Cir.BAP (Mass.) Feb 04, 2013) (NO. ADV 11-01349-WCH, BAP MB 12-025, BR 11-17703-WCH). ■

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8 Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (2005) (codified as amended in scattered sections of 11 U.S.C.A.).

9 Benjamin Ellison, 2013 No. 2 Norton Bankr. L. Adviser NL 1 Norton Bankruptcy Law Adviser February 2013 Volume 2013, Issue 2 Norton Bankruptcy Law Adviser, Unable to Receive a Discharge under 11 U.S.C.A. § 1328(f)(1): After BAPCPA, May "Chapter 20" Debtors Strip Off Valueless Home Mortgages?

10 *In re Okosisi*, 451 B.R. 90 (Bankr. D. Nev. 2011).

11 *In re Victorio*, 454 B.R. 759 (Bankr.S.D.Cal. Jul 08, 2011) (NO. 10-07125-LT13).

12 *See also*, Special commentary: Bifurcation and avoidance, or "stripping," of liens, security interests, and encumbrances held by undersecured creditors by rehabilitating and liquidating debtors in bankruptcy, 158 A.L.R. Fed. 1 (1999); Bankruptcy Practice Handbook § 8:96, Bifurcation of liens in plan-Effect of no discharge (2012); Bankruptcy Practice Handbook § 8:129, Chapter 13 "cramdown"-Lienstripping (2012); Bankruptcy Service Lawyers Edition § 17:147, Liens (2013); Bankruptcy Service Lawyers Edition § 17:219, Reinstatement of voided lien (2013); Bankruptcy Service Lawyers Edition § 17:220, Reinstatement of voided lien-Illustrative particular applications (2013) Bankruptcy Service Lawyers Edition § 50:709, Prior discharge-Under Chapter 7, 11, or 12 [§1328(f)(1)] (2013); Chapter 13 Practice and Procedure § 12:23, Effect of debtor's ineligibility to receive discharge on secured claims and "lien-stripping" provisions of plan; "Chapter 20" cases (2012); Consumer Bankruptcy Handbook with Forms § 2:16, Property of estate; exempt property-Lien avoidance (2013); Consumer Bankruptcy Manual § 5:71, Modifying rights of holders of secured and unsecured claims-Secured claims (2012); Ginsberg & Martin on Bankruptcy § 15.04, THE CHAPTER 13 PLAN (2012); 2013 NO. 1 Norton Bankruptcy Law Adviser NL 1, Eligible to File but Unable to Receive a Discharge under 11 U.S.C.A. § 1328(f)(1): Ellison, After BAPCPA, May "Chapter 20" Debtors Strip Off Valueless Home Mortgages? (2013); 2013 NO. 2 Norton Bankruptcy Law Adviser NL 1, Unable to Receive a Discharge under 11 U.S.C.A. §1328(f)(1): After BAPCPA, May "Chapter 20" Debtors Strip Off Valueless Home Mortgages? (2013)(article is in two parts).

Article 9 Amendments continued from p. 6

debtor's surname must be provided in the part of the financing statement designated for the surname.[28]

The name of the debtor that appears on the UCC-1 is extremely important, of course, for indexing and searching, and the application of Article 9's standards can be problematic, especially in the case of individuals. As another new comment suggests, filers may feel they are on their own in a confusing world:

> Article 9 does not determine the "individual name" of a debtor. Nor does it determine which element or elements in a debtor's name constitute the surname. In some cases, determining the "individual name" of a debtor may be difficult, as may determining the debtor's surname. This is because in the case of individuals, unlike registered organizations, there is no public organic record to which reference can be made and from which the name and its components can be definitively determined.
>
> Names can take many forms in the United States. For example, whereas a surname is often colloquially referred to as a "last name," the sequence in which the elements of a name are presented is not determinative. In some cultures, the surname appears first, while in others it may appear in a location that is neither first nor last. In addition, some surnames are composed of multiple elements that, taken together, constitute a single surname. These elements may or may not be separated by a space or connected by a hyphen, "i," or "y." In other instances, some or all of the same elements may not be part of the surname. In some cases, a debtor's entire name might be composed of only a single element, which should be provided in the part of the financing statement designated for the surname.[29]

Thus, if there is any doubt which word is the surname or the first personal name or additional names, the easiest way to obtain comfort will unfortunately be to file for additional debtors, to be sure that all of the bases are covered. Article 9 presents these rules, albeit more clearly than it did before the 2013 Amendments, but the preparer must apply them.

Name Change Rules

This is not the end of the analysis, however. If a driver's license expires, then the person's name changes back to whatever it is in the absence of a driver's license, pursuant to the other options in Alternative A. If they are different, then the Article 9 name-change rules apply and collateral acquired by the debtor more than four months after the change is not covered by an after-acquired property clause, unless a new financing statement is filed before that four-month window closes.

> If ~~a debtor so changes its~~ *the* name that a filed financing statement *provides for a debtor* becomes *insufficient as the name of the debtor under Section 9-503(a) so that the financing statement becomes* seriously misleading under Section 9-506, (1) the financing statement is effective to perfect a security interest in collateral acquired by the debtor before, or within four months after, the ~~change~~ *filed financing statement becomes seriously misleading*; and (2) the financing statement is not effective to perfect a security interest in collateral acquired by the debtor more than four months after the ~~change~~ *filed financing statement becomes seriously misleading*, unless an amendment to the financing statement which renders the financing statement not seriously misleading is filed within four months after ~~the change~~ *the financing statement became seriously misleading*.[30]

SUMMARY:

Individual Debtors' Names

Trustees already ask for a debtor's driver's licenses. In Alternative A states, the advisor to an individual debtor should also ask if he or she has had a different license or ID or used a different name and watch for name changes. Then, the advisor should run a search in the name exactly as it appears on the current license or, if the debtor has no license or ID, run the search using the surname name and first personal name. If the creditor's filing is not revealed, inquire further into other possible "individual names." Ultimately, if a filing is not revealed, the creditor may be vulnerable to an argument that its security interest is not perfected.

So, for secured parties, it will be prudent to note the license expiration date and to follow up and determine whether the driver's license is going to be renewed and, if so, in the same name. The new comments provide a helpful elaboration on these name-change rules for individuals, which will become important issues for review by bankruptcy advisors and may be potential headaches for creditors who are not diligent:

> Example 1: Debtor, an individual whose principal residence is in California, grants a security interest to SP in certain business equipment. SP files a financing statement with the California filing office. Alternative A is in effect in California. The financing statement provides the name appearing on Debtor's California driver's license, "James McGinty." Debtor obtains a court order changing his name to "Roger McGuinn" but does not change his driver's license. Even after the court order issues, the name provided for the debtor in the financing statement is sufficient under Section 9-503(a). Accordingly, Section 9-507(c) does not apply.
>
> ...
>
> Under Section 9-503(a)(4) (Alternative A), if the debtor holds a current (i.e., unexpired) driver's license issued by the State where the financing statement is filed, the name required for the financing statement is the name indicated on the license that was issued most recently by that State. If the debtor does not have a current driver's license issued by that State, then the debtor's name is determined under subsection (a)(5). It follows that a debtor's name may change, and a financing statement providing the name on the debtor's then-current driver's license may become seriously misleading, if the license expires

28 UCC § 9-503 Cmt. 2.d.

29 UCC § 9-506(b) & (c).

30 UCC § 9-507(c).

and the debtor's name under subsection (a)(5) is different. The same consequences may follow if a debtor's driver's license is renewed and the names on the licenses differ.

> Example 2: The facts are as in Example 1. Debtor's driver's license expires one year after the entry of the court order changing Debtor's name. Debtor does not renew the license. Upon expiration of the license, the name required for sufficiency by Section 9-503(a) is the individual name of the debtor or the debtor's surname and first personal name. The name "James McGinty" has become insufficient.

> Example 3: The facts are as in Example 1. Before the license expires, Debtor renews the license. The name indicated on the new license is "Roger McGuinn." Upon issuance of the new license, "James McGinty" becomes insufficient as the debtor's name under Section 9-503(a).[31]

Registered Organizations

Under Article 9, a "registered organization" is a corporation, LLC or similar entity that is created with what might be thought of as an institutional "birth certificate," filed as a public record with the state. Use of the state records to determine the entity's correct name has led to two types of confusion, both of which are dealt with by the 2013 Amendments.

The first area of confusion arises from these questions: What counts as the record in the state of organization, from which the registered organization's name is to be taken? Is it the document filed by the organizers or is it the Secretary of State's database? Is it the name in Secretary of State's indexing system? Or, is it the name that actually appears on the face of document - the "public organic record"?

It was somewhat unclear after 2001 whether the correct name was the one that the state had recorded in its indexing system or whether it was the name that actually appeared on the face of the document filed at the time of organization. The revised definition of registered organization is one organized solely under the law of a single state by the filing of a public organic record with the jurisdiction.[32] The phrase "public organic record" is new. It is a record that is available to the public for inspection and consists of the record filed with the state to form or organize the debtor and any subsequent filings.[33] It is this record that provides the name -- not, for example, the name recorded by the filing office in its database or on its website, if that is different from the name that appears in the public organic record. The new comments make this clear:

SUMMARY:

Registered Organizations' Names

The advisor should obtain a copy of the debtor's "public organic record," as newly-defined in the 2013 Amendments, and focus on the name stated to be the debtor's name in the text of the document. (This commonly appears in a separate paragraph, saying, "This corporation's name shall be ...," or similar words.) Run a search in that name, exactly as it is spelled, abbreviated, etc., in the public organic record. If the creditor's UCC-1 is not reported by the filing office, it may be vulnerable to the argument that its security interest is not perfected, because the name was "seriously misleading" as a matter of law.

> Not every record concerning a registered organization that is filed with, or issued by, a State or the United States is a "public organic record." For example, a certificate of good standing issued with respect to a corporation or a published index of domestic corporations would not be a "public organic record" because its issuance or publication does not form or organize the corporations named.[34]

The second source of confusion arises where there is inconsistency in the public organic record itself. For example, numbers, whether spelled out or numerical, may be inconsistent within the document. Words with common abbreviations may be abbreviated at one point in the document and spelled out at another. There may also be typographical errors in capitalization, spacing and spelling. Which version of the name is correct? The 2013 Amendments now tell us that the name to use from that public organic record is the name that is stated to be the name.[35] In other words, the name in the title of the document or in the signature block will not control if those are different from the provision in the document that actually states what the entity's name is. If so, filers and searchers should look for the name that is in the body of the document where the name is declared.

Conclusion

There are other changes taking effect in 2013 which will be the subject of subsequent parts of this article. None, however, is more significant than the name-change rules. The difficulty of determining debtors' names has caused headaches for everyone involved with an Article 9 secured transaction: the professionals documenting the original deals, the professionals evaluating the documentation in the context of bankruptcy or insolvency and the courts attempting to resolve conflicts. The 2013 Amendments will make these rules easier for everyone to understand and apply. ■

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31 UCC § 9-507 Cmt. 4.

32 "'Registered organization' means an organization formed or organized solely under the law of a single State or the United States ~~and as to which the State or the United States must maintain a public record showing the organization to have been organized~~ *by the filing of a public organic record with, the issuance of a public organic record by, or the enactment of legislation by the State or the United States. The term includes a business trust that is formed or organized under the law of a single State if a statute of the State governing business trusts requires that the business trust's organic record be filed with the State.*" UCC § 9-102(a)(70)(71).

33 UCC § 9-102(a)(68).

34 UCC § 9-102 Cmt. 11.

35 UCC § 9-503(a)(1).

***Value of NOLs** continued from p. 13*

tax attribute" would also be much smaller in value than the past refund because there was no reasonable prospect of the debtor increasing his then current income in years following the election.[72] Additionally, the debtor had no reasonable prospect of selling his S-Corps or operating them successfully, which might have led to a higher future income and consequently a greater future tax attribute.[73]

Issues (c) and (d) were appealed to the district court, which affirmed the bankruptcy court's award of summary judgment to the trustee.[74] On the issue of whether the carryback waiver constituted a property interest, the district court held that the bankruptcy court did not err in relying on *Segal*, although the case predated the Bankruptcy Code.[75] The district court also noted that the only two cases to have considered a similar issue, *In re Russell* and *In re Feiler*,[76] held that the carryback waiver constituted a property interest.[77]

Regarding requirement (d), the court concluded that the waiver of the carryback refund constituted a transfer under the Bankruptcy Code.[78] The court found the reasoning of the bankruptcy court and *In re Feiler* to be persuasive in this matter, finding that the waiver was a trade between the debtor and the IRS where the debtor traded his right to a present refund for the right to carry it forward.[79]

In conclusion, the court also addressed the argument that the trustee's avoidance powers under Bankruptcy Code § 548 are not applicable to an irrevocable election under the Tax Code.[80] Similar to the court in *In re Russell*, the district court distinguished between revocation and avoidance of an irrevocable tax election.[81] The court noted that a trustee's avoidance powers are often used to avoid transfers classified as 'irrevocable' under state law.[82] In fact, the very essence of granting the trustee such extraordinary powers of avoidance is to avoid transactions that are not otherwise revocable by the debtor.[83]

The United States argued that the trustee should not be allowed to avoid the irrevocable election because Congress did not explicitly exempt trustees from the irrevocability of Tax Code § 172(b)(3).[84] The United States relied on a Supreme Court case, *Midatlantic Nat'l Bank v. New Jersey*,[85] which stated that "[i]f Congress wishes to grant the trustee extraordinary exemption from nonbankruptcy law, 'the intention would be clearly expressed, not left to be collected or inferred from disputable considerations of convenience in administering the estate of the bankrupt.'"[86] The district court held that Congress made such a clear expression of intent to exempt trustees from the irrevocability of the election by granting extraordinary avoidance powers under Bankruptcy Code § 548.[87]

In re White Metal Rolling and Stamping Corp

The *In re White Metal Rolling and Stamping Corp.* case revisited an issue first introduced by the seminal case *Jump v. Manchester Life and Casualty Management Corp*.[88, 89] The debtor in both cases was a subsidiary, which was filing consolidated tax returns prior to liquidation. In an almost identical set of events, the debtor-subsidiary incurred net operating losses, which were used to offset the income of the entire group of companies filing the consolidated tax returns.

The debtor-subsidiary in *In re White Metal Rolling and Stamping Corp.* filed a voluntary chapter 7 petition, and the trustee brought a multitude of claims including breach of fiduciary duty, unjust enrichment, and avoidance actions based on the use of NOLs by the consolidated group.[90]

The bankruptcy court held that the trustee failed to state legally sufficient breach of fiduciary duty and unjust enrichment claims based on the consolidated group's use of NOLs.[91] The court framed the issue as such: "what rights, if any, does the loss member [debtor-subsidiary] have in the refund, or more generally, against the profitable members who benefit from the application of its NOL."[92] Initially, the court turned its attention to the value of the NOLs to the loss member, relying on the case *In re Coral Petroleum, Inc.*,[93] which stated that the NOL's value to the loss corporation depends on its ability to use the NOL to reduce its past or future tax liabilities.[94] The loss corporation could also derive such value from its ability to market the NOLs to a profitable corporation, providing such a transaction survives the Tax Code's rules against trafficking in losses.[95] The bankruptcy court could not consider the argument on marketability of the NOLs because it was not alleged in the complaint.[96] The court nevertheless cast some doubt as to the viability of this argument because of the lack of clarity on whether such marketability would be an asset of the parent, sole shareholder of the subsidiary, or the subsidiary that generated the loss.[97]

Relying on the holding of *In re Coral Petroleum, Inc.*¸ the bankruptcy court further stated that the NOL's value to the loss member, when limited to the right of refund, will be capped at the amount of tax paid by the loss member during the carryback year.[98] The loss member will not have the right to any excess refunds generated by

72 *Id.*
73 *Id.*
74 *United States v. Kapila*, 402 B.R. 56 (D. Fla. 2008).
75 *Id.*
76 *In re Feiler*, 218 F.3d 948 (9th Cir. 2000) aff'g 230 B.R. 194, aff'g 218 B.R. 957 (Bankr. N.D. Cal. 1998).
77 *United States v. Kapila*, 402 B.R. 56 at 60.
78 *Id.* at 61.
79 *Id.*
80 *Id.* at 63.
81 *Id.*
82 *Id.*
83 *Id.*
84 *Id.* at 64.
85 *Id.*
86 *Id.*
87 *Id.*
88 *Jump v. Manchester Life Cas. Managements Corp.*, 579 F.2d 449 (8th Cir. 1978).
89 *Nisselson v. Drew Industries, Inc.* (*In re White Metal Rolling and Stamping Corp.*), 222 B.R. 417 (Bankr. S.D.N.Y. 1998).
90 *Id.* at 420.
91 *Id.* at 426.
92 *Id.* at 417.
93 *In re Coral Petroleum, Inc.*, 60 B.R. 377, 385 (Bankr. S.D. Tex. 1986).
94 *In re White Metal Rolling and Stamping Corp.*, 222 B.R. 417 (Bankr. S.D.N.Y. 1998).
95 *Id.* at 423.
96 *Id.*
97 *Id.*
98 *Id.*

the consolidated group.[99] Concerning the right to carry forward the NOLs, the court relied on the case mentioned above, *Jump v. Manchester Life and Casualty Management Corp.*: The right of a loss member to carry forward the NOLs is limited to the extent that it could use the NOLs to offset future income or bargain with the members of the consolidated group.[100]

Applying the above principles to the facts, the bankruptcy court determined that the debtor did not have a right to the NOL carry forward because its liquidation meant it had no prospect of future income.[101] Also, the carry forward added no bargaining power to the debtor because the debtor consented to the consolidated tax returns, the use of NOLs was consistent with past practice, and the members had already bargained by entering into a Tax Matters Agreement.[102]

Given the above conclusions and relying on *Jump*, the bankruptcy court held that the profitable members of the consolidated group are not liable for breach of fiduciary duty and unjust enrichment for the use of NOLs which the loss member itself could not use.[103] In fact, the common officers of the consolidated group have a fiduciary duty to use the NOLs to offset income of other members when the loss member cannot utilize it.[104]

The court similarly dismissed the fraudulent transfer claims, holding that the NOLs had no value to the estate; hence no claim could lie for their transfer.[105] The court noted that the only viable claim in such cases could be a breach of contract, if the debtor did not receive what was promised under the tax allocation agreement.[106]

In re Forman Enterprises, Inc.

The case of *In re Forman* sheds further light on the claims of unjust enrichment and fiduciary duty while addressing the added issue of a resulting trust. The chapter 7 debtor in *In re Forman*, as an S-Corp, was not responsible for the payment of its own taxes, rather the taxes as well as the NOLs were passed up to its shareholders.[107]

After filing the petition, the trustee brought a complaint alleging unjust enrichment and breach of fiduciary duty against the shareholders and directors of the debtor based on their use of the NOLs in their personal tax returns.[108] The court first considered and denied a motion to dismiss the complaint filed by the defendants on January 31, 2002.[109] The defendants argued against the unjust enrichment claim under *In re White Metal* that the NOLs had no value to a liquidating S-Corp.[110] The bankruptcy court found this argument to be unpersuasive holding that the unjust enrichment claim should not focus on the value of the NOL to the debtor.[111] Instead the claim should focus on whether the NOLs provided substantial benefit to the defendants which would be unconscionable for them to retain.[112, 113] Additionally, the court noted that the defendants should focus on the tax refunds, which had considerable value to the defendants, instead of the value of the NOLs.[114]

The bankruptcy court decided the case on its merits on August 2, 2002, entering a judgment in favor of the defendants.[115] The court found that the defendants were not unjustly enriched by their use of the debtor's NOLs because they paid the debtor's income taxes in profitable years in return for the enjoyment of tax refunds in loss years.[116] There was also no evidence that the defendants planned the use of NOLs "on the sly" to deprive the creditors of value.[117] The court noted that the disconcerting result of their holding would be to deprive the creditors of value; however, this result was not sufficient for the court to exercise equity measures.[118]

The court further held that the defendants did not breach their fiduciary duty to the debtor because there was no unjust enrichment.[119, 120] Similarly, there was no need to have a constructive trust imposed in favor of the debtor's creditors with respect to the tax refunds because there was no unjust enrichment to prevent.[121]

Analysis

The first pair of cases discussed above, *In re Russell* and *Kapila v. United States*, pertain to the intersection of causes of action under federal bankruptcy law with tax law. The second pair of cases, *In re White Metal and Stamping Corp.* and *In re Forman Enterprises, Inc.*, pertains to state law causes of action and tax law in the bankruptcy context. First we will address the bankruptcy law causes of action.

Causes of Action against the Use of NOLs under Bankruptcy Law

The first hurdle for a trustee/Committee (only referred to as trustee henceforth), as demonstrated by the threshold question in *In re Russell,*[122] is to convince the bankruptcy court that the intersection of bankruptcy and tax law does not bar the claim. The courts in *Kapila* and *In re Feiler* (not discussed in detail) also

99 *In re White Metal Rolling and Stamping Corp.*, 222 B.R. 417 (Bankr. S.D.N.Y. 1998). at 424.
100 *Id.*
101 *Id.* at 426.
102 *Id.*
103 *Id.*
104 *Id.*
105 *Id.* at 427.
106 *Id.*
107 *Official Comm. Of Unsecured Creditors v. Forman* (*In re Forman Enterprises, Inc.*), 273 B.R. 408 (Bankr. W.D.Pa. 2002).
108 *Id.*
109 *Id.*
110 *Id.* at 412.
111 *Id.* at 413.
112 The three elements of an unjust enrichment claim in Pennsylvania are: (1) that a benefit was conferred on the defendant; (2) that defendant retained the benefit; (3) that it would be inequitable for defendant to retain the benefit without paying its value.
113 *Id.*
114 *Id.*
115 *Official Comm. Of Unsecured Creditors v. Forman (In re Forman Enterprises, Inc.)*, 281 B.R. 600 (Bankr. W.D.Pa. 2002).
116 *Id.* at 608.
117 *Id.* at 609.
118 *Id.* at 608.
119 *Id.* at 610.
120 "The test for breach of fiduciary duty is whether a director was unjustly enriched by his or her actions." *Seaboard Industries v. Monaco*, 442 Pa. 256, 262 (1971).
121 "The controlling factor in determining whether a constructive trust ought to be imposed is whether it is necessary to prevent unjust enrichment." *Roberson v. Davis*, 397 Pa. Super. 292, 296 (1990).
122 The threshold question being "whether a trustee's powers under the Bankruptcy Code can be used to invalidate a debtor's irrevocable election under the Tax Code."

struggled with the same question: whether a trustee's avoidance powers can avoid an irrevocable tax election. All three courts concluded similarly that a trustee can avoid such elections as long as the statutory requirements of Bankruptcy Code section 548 or 549 are satisfied.

These three decisions, which allow a trustee to avoid irrevocable tax elections under bankruptcy law, are likely to be followed by other courts in the future for three principal reasons. First, the decisions are consistent with the extraordinary avoidance powers granted to the trustee by Congress. A trustee's avoidance powers are often used to avoid transfers such as sales of property which are, in every sense of the word, irrevocable. Second, it is unclear as to whether there is in fact a controversy in allowing the trustee to *avoid* the election, as opposed to *revoking* it. Although the practical effect of avoidance and revocation of an irrevocable election is the same for the IRS, from a legal perspective avoidance of the election makes it such that the debtor never made the election to begin with.

Finally, the ultimate injury to the IRS resulting from the avoidance of the irrevocable tax election is minimal. Instances which implicate the avoidance of the irrevocable tax election are few, and are contingent on the satisfaction of statutory requirements listed in Bankruptcy Code § 548 and § 549. The court in *Kapila* classified the injury to the IRS as "relatively minimal since absent an election by the taxpayer, the normal practice is for the IRS to carry NOLs back to previous taxable years to be applied against previous tax bills, normally resulting in a tax refund."[123] Compared to such minimal injury to the IRS, the potential harm to the creditors of not allowing the trustee to avoid the irrevocable tax election is great. This harm is especially apparent in cases where the debtor elected to forego the carryback refund with an "actual intent to hinder, delay or defraud"[124] the creditors. Allowing such actions under the guise of irrevocable elections "is nothing more than money laundering through the kind auspices of the United States."[125]

The district court in *In re White Metal* had to address a related issue on the intersection of bankruptcy and tax law on defendant's motion to withdraw the reference from the bankruptcy court depending on whether the claims in the adversarial proceeding required the "substantial and material consideration" of federal tax law.[126, 127] The district court denied the motion, relying on the holding of *In re Prudential Lines* that bankruptcy law determines the question of whether the debtor's interest in property is included in the property of the estate.[128] This, along with the above holdings, shows that courts have unequivocally sided with the applicability of bankruptcy law to issues relating to the use of NOLs by the debtor, its shareholders, and directors.

Once the trustee has overcome the above barriers arising from the intersection between bankruptcy and tax laws, the focus will shift to the avoidance claims under Bankruptcy Code sections 548 and 549. Although the analysis under these sections will differ based on the facts, the cases discussed above provide some guidance which may be applicable to most avoidance actions concerning NOLs. The court in *Kapila* suggests that a trustee should find it easy to prove the election was not made for reasonably equivalent value under § 548(b) constructive fraud.[129] The court notes that "[i]t is difficult to imagine how a debtor who is clearly insolvent and on the cusp of bankruptcy filing could ever receive reasonably equivalent value when he gives up his NOL carryback in exchange for future contingent tax attributes."[130]

In re Russell provides further guidance in cases where the debtor made a prepetition and postpetition election. The court suggests that as long as the trustee can prove the prepetition election was a constructive fraudulent transfer under § 548(b), it is more than likely that the postpetition election is avoidable under § 549.[131] The court does note, without providing examples, that there could be situations where the prepetition transfer was constructively fraudulent and yet the postpetition transfer was made in the ordinary course of business.[132] Conceivably, a situation where (1) the debtor has a long history of making the election, (2) the creditors knew that the debtor made such elections, and (3) similarly situated businesses in the industry also made the election would satisfy the ordinary course of business requirement.

Causes of Action against the Use of NOLs under State Law

The three state law based claims against the use of NOLs discussed in the cases above are: unjust enrichment, breach of fiduciary duty, and violation of a constructive trust. The unjust enrichment claim seems most important, as the other two claims follow from the presence of unjust enrichment.[133]

The fact that these claims arise from state law means it is quite possible that the requirements for each claim will change from state to state. Adding further uncertainty to the process of bringing a claim under state law, the courts in *In re White Metal* and *In re Forman* differed in their opinion of unjust enrichment. The court in *White Metal* chose to focus on the value of the NOLs to the debtor, while the court in *Forman* preferred focusing on the value of tax refunds to the defendants. The *Forman* court also found the defendant's arguments under *White Metal* to be unpersuasive. The bankruptcy court in *In re Woodside* (not discussed in detail) seemed to follow the *Forman* court by holding that a claim of unjust enrichment hinges on whether retention of benefits would be inequitable, instead of the value of NOLs to the debtor.[134] This case also provides an example of unjust enrichment in the transaction as the debtor

123 *United States v. Kapila*, 402 B.R. 56 at 64.
124 11 U.S.C. § 548(a)(1) (2006).
125 *Kapila v. United States*, 386 B.R. 361, 370 (2008).
126 28 U.S.C. § 157(d) on motion to withdraw: "The district court shall on timely motion of a party, so withdraw a proceeding if the court determines that resolution of the proceeding requires consideration of both title 11 and other laws of the United States regulating organizations or activities affecting interstate commerce."
127 *Nisselson v. Drew Industries, Inc.* (*In re White Metal Rolling and Stamping Corp.*), 217 B.R. 981.
128 *Id.*
129 *Kapila v. United States*, 386 B.R. 361 at 370 n.6.
130 *Id.*
131 *In re Russell*, 187 B.R. 287 at 292.
132 *Id.*
133 Requirements for claims based on breach of fiduciary duty and violation of a constructive trust will vary according to state law. Pennsylvania state law in In re Forman required the presence of unjust enrichment for the satisfaction of the other two claims. It is possible that other states will not have the same requirements.
134 *In re Woodside Group, LLC*, 427 B.R. 817 (Bankr. Cal. 2010).

and its shareholders secretly conspired to deprive the creditors of value by utilizing the NOLs.[135]

Conclusion

It is clear from the cases and statutes discussed above that NOLs have value to the bankruptcy estate. What that value is will differ from case to case: the value of NOLs to a liquidating S-Corp can be zero, while the same NOLs can have a substantial carry forward value to a corporation about to reorganize under chapter 11. It is up to the trustee to investigate any prepetition and postpetition actions affecting NOLs, including tax elections such as § 172(b). If the trustee suspects that any such actions affected the debtor's NOLs, there is a wide variety of claims under bankruptcy and state law which could be used to avoid the action or seek a refund. ■

[135] *In re Woodside Group, LLC*, 427 B.R. 817 (Bankr. Cal. 2010).

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***NHL Bankruptcies** continued from p. 16*

the public became aware that the Phoenix Coyotes were losing money at a high rate and were being funded directly by the NHL. The media reports were minimized by NHL Commissioner Gary Bettman but secretly the NHL had taken over operations of the Coyotes. In May 2009 team owner Jerry Moyes caused the entity through which he held the team (Dewey Ranch Hockey, LLC) to file a chapter 11 petition,[17] just hours before receiving Bettman who was to present a potential offer to purchase. It was rumored that the NHL wanted to move the team back to Winnipeg. Moyes intended to sell the team to Canadian billionaire Jim Balsillie, who intended to purchase the team out of bankruptcy and move it to Hamilton, Ontario without being restricted by the NHL's rules on relocation.[18]

From May 2009 until September 2009, hearings were held in Phoenix bankruptcy court to determine the fate of the Coyotes and the holding company. In addition to Balsillie, two other bidders surfaced—Chicago White Sox owner Jerry Reinsdorf and Ice Edge Holdings, Inc., a group of Canadian and American businessmen led by Anthony Leblanc (a former Research in Motion executive).[19] In the end only Balsillie and the NHL submitted bids; Balsillie's bid offered a $212 million purchase price of which $22 million would go to Gretzky. The NHL opposed Balsillie's move to relocate the team to Hamilton, Ontario because that would infringe on the Toronto Maple Leaf's territory. As in the Pittsburgh Penguins bankruptcy, the NHL asserted that the franchise could not be moved without their approval. As part of the 2003 move to Glendale, the Coyotes had agreed to play their home games in Glendale through 2035 and in the event of breach would pay liquidated damages of $795 million. Moyes, who wanted to accept the Balsillie bid, argued that the NHL rules were in violation of US anti-trust laws and that Bankruptcy Code Sections 363 and 365 permitted sale of the debtor assets and rejection of any debtor contracts. (Of course, the rejection of a contract would give rise to a claim for the unexecuted portion of the contract, but like any claim, recovery would be limited to the assets available in the bankruptcy estate).

[17] *In re: Dewey Ranch Hockey, LLC* Case No. 2:09-bk-09488-RTBP.

[18] Phoenix Coyotes bankruptcy. From Wikipedia, the free encyclopedia.

[19] Toronto Globe and Mail, Sept. 6, 2012.

Ultimately the bankruptcy judge ruled against the Balsillie bid—holding that anti-trust did not apply, giving weight to the damage to the City of Glendale and giving weight to the NHL rules that forbid such a move without their approval.[20]

After the Balsillie bid was rejected there were many more false starts with Reinsdorf, Ice Edge Holdings (another group led by San Jose Sharks former CEO Greg Jamison)[21] and another feeler from Chicago businessman Matthew Hulsizer[22]—all of which came to naught. Finally, after further negotiations and changes the court accepted the NHL's bid on November 2, 2009. That agreement provided a total package of cash and debt assumption of $128 million. In addition, the NHL would assume the rights and obligations under the arena lease; however, the lease would terminate in 2010, not 2035, and the city's liquidated damages would be limited to $14 million in the event of a move.[23] Apparently, no third party creditor suffered a loss. Since then, the NHL has kept the team in Phoenix on a year to year basis, still looking for a buyer, presumably preferring one that would keep the team in Phoenix. Although the team has made the playoffs three years in a row despite all the turmoil around them, attendance continues to lag.

Conclusion

Little definitive emerges from the recent hockey cases on the validity of the restrictive clauses in the NHL's Constitution and the obligation of teams to remain in cities who had built them expensive arenas vis a vis the authority of the bankruptcy court to deliver clear title without limitations on assignment and the power to reject contracts including stadium leases. The next article will examine how those issues play out in the Texas Rangers and Los Angeles Dodgers bankruptcy cases. ■

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[20] Minute Entry Order on Motion under BC 363 and 365, June 15, 2009.

[21] Phoenix Coyotes bankruptcy. From Wikipedia, the free encyclopedia.

[22] ESPN.com: NHL Thursday, January 31, 2013.

[23] Stipulated Order Approving Amended and Clarified Bid, Nov. 2, 2009.

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William Nolan
FTI Corporate Finance & Restructuring
Charlotte, NC

Alex Verba
Zolfo Cooper
New York, NY

Michael Han
AlixPartners, LLP
Dallas, TX

Todd Plugge
High Ridge Partners Inc
Chicago, IL

Jeffrey Yim
Alvarez & Marsal North America, LLC
Chicago, IL

Deven Patel
Ernst & Young LLP
New York, NY

Brendan Miles
NewOak Capital LLC
New York, NY

Mark Gilbreth
Deloitte CRG
New York, NY

Justin Koehler
Protiviti Inc
Richmond, VA

Louis Robichaux
Deloitte CRG
Dallas, TX

Steven Santiago
Navigant Capital Advisors LLC
Chicago, IL

NEW CDBVS

Joseph Gardemal III
Alvarez & Marsal North America, LLC
Washington, DC

CLUB 10

Firms with 10 or more professionals who have active CIRA certification or have passed all three examinations:

FTI Consulting, Inc.	80
Alvarez & Marsal North America, LLC	70
AlixPartners, LLP	68
Deloitte./Deloitte CRG	47
Huron Consulting Group LLC	30
KPMG LLP	29
Mesirow Financial Consulting LLC	25
Ernst & Young LLP	24
Capstone Advisory Group LLC	23
Navigant Capital Advisors LLC	21
Grant Thornton LLP	19
Conway MacKenzie, Inc.	17
Protiviti Inc	17
Zolfo Cooper	17
PricewaterhouseCoopers LLP (PwC)	16
Loughlin Management Partners + Company	15
BDO Consulting LLP	13
CohnReznick LLP	13
Berkeley Research Group, LLC	13
Office of the U.S. Trustee	11

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