AIRA | Association of Insolvency & Restructuring Advisors™

Journal

News from the Association of Insolvency & Restructuring Advisors

Volume 25, Number 1 – April/May 2011

The Common Interest Privilege: Two Recent Cases Clarify Its Application to Protect Plan Negotiations

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Two recent decisions from the United States Bankruptcy Court for the District of Delaware add clarity to the application of the common interest privilege to plan negotiations. In the case of Leslie Controls, Inc. ("Leslie"),[1] Bankruptcy Judge Christopher S. Sontchi held that parties to a plan pursuant to 11 U.S.C. § 524(g) could rely on their common interest in maximizing the debtor's assets to withhold from discovery certain documents exchanged during their prepetition negotiations. Following *Leslie*, Bankruptcy Judge Kevin J. Carey similarly concluded that plan proponents in the Tribune Company bankruptcy proceedings could rely on a common interest to withhold the communications they shared while mediating a settlement and proposed plan from discovery sought by proponents of a competing plan.[2]

LESLIE—SHARED INTEREST IN PRESERVING AND MAXIMIZING DEBTOR'S ASSETS

In *Leslie*, Judge Sontchi clarified the scope of the common interest privilege and found that the debtor's insurers were not entitled to discovery of certain documents exchanged by the debtor and other parties in the course of developing a prenegotiated plan.[3] *Leslie* demonstrates that the parties negotiating a plan need not share a complete unity of interests on a legal position for the common interest privilege to apply. Rather, the common interest privilege will apply to the extent they have a shared cognizable legal interest.

On July 12, 2010, Leslie filed a plan it had negotiated prepetition with an ad hoc committee representing asbestos plaintiffs (the "Ad Hoc Committee") and Leslie's proposed future claimants' representative (the "Pre-Petition FCR") (Leslie, the Ad Hoc Committee and the Pre-Petition FCR are collectively referred to as the "Plan Parties"). Subsequently, two of Leslie's insurers sought 26 documents that Leslie had shared with the Ad Hoc Committee and the Pre-Petition FCR. The Plan Parties withheld the documents on the grounds that they were protected under the common interest doctrine.[4] The documents included a memorandum from Leslie's insurance counsel analyzing the effect of the insurers' likely coverage positions and communications among the Plan Parties regarding that advice.[5] On September 21, 2010, Judge Sontchi resolved the discovery dispute by holding that the common interest privilege protected the documents because they concerned and were exchanged in furtherance of the Plan Parties' shared legal interest in preserving and maximizing the debtor's total asset "pie," even though the Plan Parties had conflicting interests as to how the "pie" ultimately would be distributed.

Preliminarily, the court found, based on *in camera* review, that the documents were protected by the attorney-client privilege and/or work product doctrine because they concerned counsel's legal analysis and mental impressions in anticipation of litigation in the bankruptcy and/or insurance-coverage proceedings.[6] Any waiver of that privilege turned on whether the debtor satisfied the standards of the common interest privilege: "The party invoking the protection of the common interest doctrine must establish: (1) the communication was made by separate parties in the course of a matter of common interest, (2) the communication was designed to further that effort, and (3) the privilege has not otherwise been waived."[7] While the privilege does not require a "complete unity of interests[,]. . . it is limited by the scope of the parties' common interest."[8]

The insurers argued that Leslie waived any privilege by sharing the documents with the Ad Hoc Committee and Pre-Petition FCR, because the Plan Parties lacked an interest that was *legal* and *common*.[9]

1 In re Leslie Controls, Inc., 437 B.R. 493 (Bankr. D. Del. 2010).
2 In re Tribune Co., Case No. 08-13141 (KJC), 2011 Bankr. LEXIS 299 (Bankr. D. Del. Feb. 3, 2011).
3 Id. at 493.
4 Id. at 495.
5 Id.
6 Id. at 497.
7 Id.
8 Id. at 500.
9 Id. at 497.

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

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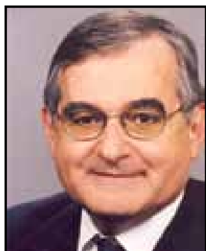

Letter from the President

Stephen Darr, CIRA, CDBV

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TERRY JONES COMPLETES 10TH YEAR WITH AIRA

In May 2011, AIRA is pleased to recognize Director of CIRA & CDBV programs, Terry Jones, for ten years of service to the Association. Terry Jones was born in Napa, CA ("in the horse and buggy days," she says) and grew up in South San Francisco. Before moving to Oregon 18 years ago, she was employed as assistant to the CFO of Oracle Corp (her former boss is still CFO). In Medford, Oregon, she worked for six years with the Medford Fire Department (Terry reports it was like getting 72 big brothers overnight) before joining AIRA in 2001 to coordinate the CIRA program and serve as an administrative assistant. Over the last 10 years she has facilitated the growth of the CIRA program and the development and growth of the CDBV program. Under Terry's coordination, the CIRA program has grown from 366 CIRAs to 1,353 CIRAs today. Also during this ten-year period, 2,650 individuals have registered for one or more parts of the CIRA course and examination.

Terry's contributions to AIRA during the last decade have been numerous. She has consistently maintained a professional attitude in accepting full responsibility in the coordination of all CIRA and CDBV courses, arranging for classroom space and catering, printing and overseeing preparation of materials, shipping materials and exams to course locations. Terry has also been responsible for maintaining records for each participant of attendance, credit for cancellations and rescheduled courses, and examination results. In all of these areas, she has demonstrated a high level of commitment and integrity.

Although Terry says AIRA *is* her life, she is always busy with a variety of interests outside of work. Her hobbies include interior decorating, cooking, and "doing the best I can do to live a long / healthy life, and spending time with family and friends." Her favorite vacation location is Hawaii.

The Board of Directors, AIRA coworkers, Professor Newton and I are extremely grateful for Terry's excellent work and commend her for carrying out her duties as Director of CIRA and CDBV Programs according to the high standards that are critical to AIRA's professional certification program. Terry, we are looking forward to ten more years!

100TH CDBV CERTIFICATE ISSUED

Erik Toth, CIRA, Director FTI Consulting Corporate Finance (shown on right) was presented with the 100th certificate in Distressed Business Valuation (CDBV) by FTI Senior Managing Director Robert Medlin, CIRA (on left).

Returning to Profitability: Successful Restaurant Restructurings in a Sluggish Economy

David M. Bagley
MorrisAnderson

Despite the current economic climate and the fact that most Americans have less discretionary income to spend on eating out, recent news in the restaurant industry has generally been good. Fast food giant McDonald's recently reported Q3 2010 same-store sales grew 2.9 percent for its US locations.[1] Quick service concepts such as Panera Bread also continue to show strength with a 3.3 percent sales increase and year-over-year earnings up 35 percent.[2] Even much-maligned high-end concepts seem to have turned a corner during 2010, for example Ruth's Chris Steakhouse reported an 8 percent increase in year-over-year sales and a return to profitability for the year.[3]

Good news for the industry has also come in the form of moderate food costs and a continued weak job market. At certain points during 2007 and 2008, franchises needed to roll out new menus twice a year to keep up with rising food costs. Now, food pricing has moderated along with a general decline in economic activity. Additionally, the unemployment rate remains high at 8.8 percent,[4] resulting in moderate labor costs compared to recent years.

However, it should be noted that these results are being compared against prior earnings periods that were not exactly stellar. Many companies accumulated huge losses during the past three years, it will take time for the industry to regain solid financial footing, and a great number of companies are still finding themselves in financially distressed situations.

While food and labor expenditures comprise a substantial portion of the cost structure of restaurants, the remaining structural costs related to facilities and ongoing capital requirements represent significant hurdles when attempting to assist restaurant franchises that find themselves in financial distress.

Two notable issues have factored as prominent catalysts for recent financial distress engagements:

- consequences of brisk expansion during the years from 2004 to 2008; and
- impact of deferred capital expenditures on the volume of sales.

Consequences of Brisk Expansion

A recent client of MorrisAnderson is a franchisee of a national brand that operates more than 90 locations throughout the southeastern United States. The author was part of a team hired to help the client work through a restructuring process. As shown in Figure 1, the franchise's main issue was a multiyear expansion into Florida which had increased its footprint by 35 percent. Initially, those units performed well, as Florida went through a prolonged economic expansion. However, starting in 2007, sales began to trend down more than 10 percent each year.

($ in 000s)

	Total debt	Cash Flow Available for Debt Service	Debt to Cash Flow Ratio	Annual debt service	Cash Flow to Debt Service Ratio
Florida units (24)	$28,000	$500	56.0	$3,500	0.1
Non-Florida units (68)	42,000	8,500	4.9	6,500	1.3
Total	$70,000	$9,000	7.8	$10,000	0.9

Due to the softness in sales, most of the Florida units were not making money before debt service, even before taking into account general and administration (G&A) expenses. During the company's expansion into Florida, property development costs went from $1 million per unit for land and building costs to more than $2 million per unit. Adding to the overall financial distress, the franchise development strategy was partially based on market penetration to support local and national advertising, so units needed to be opened following a prescriptive development schedule.

In the simplest terms, the cost of a franchise facility must usually be less than 85-90 percent of the location's annual revenues. Normally, a restaurant should have rent (or fee-simple building debt payments) at 7 percent or less of its sales. If the property is valued at a normalized 8-9 percent capitalization rate, the facility, and subsequently the building value, should represent around 85-90 percent of sales. With sales stagnating at approximately $630,000 per unit and building costs near $2 million per unit, structurally the economics of the situation could not work.

Fortunately the owners got the help they needed early on and the entire organization was successfully restructured through a combination of:

- Spinning off 14 units to one of the partners
- Re-amortizing short term leasehold improvement
- Remodeling notes from less than 3-5 years
- Closing 15 locations
- Conveying real properties to the senior lenders based on liquidation value of the real property; and
- Refinancing a $15 million portion of the debt with a new lender

The main key to this successful restructuring was a strong base of established units, a good management team that was proactive in seeking early intervention and committed to the positive changes, and some creative solutions plus a little luck in finding a local bank willing to lend into a potentially tenuous situation. Many other companies in similar situations often face steep financial losses and more limited choices in bankruptcy because they did not seek good financial advice when the problems first became apparent.

1 McDonald's Q1 2011 press release, April 21, 2011.
2 Panera Bread Q1 2011 press release, April 26, 2011.
3 Ruth's Chris Steakhouse press release, February 18, 2011.
4 Bureau of Labor Statistics, March 2011 Seasonal Unemployment Rate.

Generally, any franchise concept with more than 30 percent new units or units that were acquired during the years from 2006 to 2009 is very likely to be in serious trouble due to the cost of their real property investments. These companies are at significant financial risk and need to work with a financial advisor that is well-versed in troubled business situations to consider possible restructuring to maximize the chances of a return to profitability along with the country's economy.

LACK OF CAPITAL EXPENDITURES: POPEYE'S FRANCHISEE CASE STUDY

Franchise operations in financial distress are all too often are hurt by the lack of capital expenditures by financially troubled chains that negatively impact bottom line results, especially in a struggling economy. Once a troubled franchise operation has gotten behind on capital expenditures it is often difficult to make up lost ground.

An example of this effect is a Popeye's franchisee with 26 locations across Alabama and Louisiana. Cash distributions and investments in non-operating real property assets had undermined the financial stability of the company. By the a Chief Restructuring Officer (CRO) was brought in to lead the company through bankruptcy, the franchisee owed the IRS $2.3 million in withholding taxes, $1 million in state sales taxes, and $600,000 in property taxes. In total, the franchisee had $30 million in debt and outstanding taxes and was only generating $25 million annually in revenues.

Capital expenditures for the franchisee were also well behind where they should have been, with about $1.5 million (about $50,000 per location) in required upgrades to systems, regular maintenance items and property fixes, like painting and parking lot improvements. Sales were lagging, with a downward 8 percent year over year trend.

During the first six months of the bankruptcy process, the franchisee was advised to invest $500,000 in systems and maintenance capital expenditures. Equipment from closed locations was utilized to improve service levels at the remaining stores. Some of these expenditures were required by the franchisor as part of a workout agreement, but they were also important for their long-term benefit of improving operational efficiency and aesthetics of remaining locations.

The benefits of these changes included improved employee morale and spirits increased managers' motivation because the parent corporation was investing in their locations. Service delivery times dropped dramatically as long-neglected equipment was fixed and returned to working order. Drive-through service times dropped from close to 300 seconds (five minutes) down to 210 seconds (three-and-a-half minutes). Several of the franchisee's locations are now below the brand standard of 180 seconds (three minutes).

One of the metrics Popeye's uses to evaluate locations is the Metric Moving Scorecard (MMS), which contains measures of customer satisfaction, level of employee training, food safety, sales and profitability. Prior to the turnaround engagement, the Popeye's franchisee scored in the bottom 10 percent of all franchisees; during the most recent reporting period they averaged 3.9/4.0 seconds and were among the top performers in the Popeye's system.

The most current sales metrics show that same store sales for the client are now up over 9 percent year over year. Not all of this growth can be attributed to the capital expenditures, but they are definitely an important part of the equation. In comparison, another Popeye's franchisee that was also behind in capital expenditures and maintenance is currently running at 2 percent year over year – seven percent less than the example franchisee is working with.

It will be interesting to see how the capital expenditures gap plays out in franchise earnings during the next three years or so. For instance, how will struggling chains like Wendy's, Arby's and Burger King keep up with the cash-generating machine of McDonald's? Those concepts that have not kept up with a normalized level of capital expenditures, repair and maintenance will be at a significant sales risk during the next several years. The major problem is the difficulty of escaping a downward spiral, with lack of funds for capital expenditures reinforcing descending sales results, played out against an already-difficult economic backdrop.

PUTTING IT ALL TOGETHER: OPERATIONS REMAIN THE KEY

One significant reason that some troubled franchises have realized successful financial outcomes is that they had strong operations personnel and a committed management team; what they were lacking was better financial leadership and a cohesive, strategic plan to remedy the causes of financial distress. Going far beyond "fixing" the balance sheet, a successful turnaround usually requires fundamental, comprehensive change.

For franchise companies where rapid expansion led to financial distress, evaluating locations, potentially consolidating operations and implementing a solid operating plan for the remaining locations are often called for. Given the complexity of rolling out these initiatives simultaneously, a medium-term workout plan is typically necessary to shepherd the company back to health.

For those companies where deficient capital expenditures may be impacting sales trends, a comprehensive evaluation of the repair and maintenance routines and a unit-by-unit review of capital expenditures are typically required.

The bottom line is that early identification of these and other similar problems, as well as a commitment to making significant changes, can lead to considerable financial improvements for franchise systems that find themselves in financial distress. And that's a win for everyone involved. ■

David M. Bagley is a Managing Director at MorrisAnderson, a Chicago-based financial and operational advisory firm with offices in New York, Atlanta, Milwaukee, Los Angeles, Cleveland, St. Louis, Minneapolis and Toronto. The firm's service offerings include performance improvement, financial advisory, interim management, turnarounds, workouts, litigation support and insolvency services and wind-downs. MorrisAnderson emphasizes hands-on advisory and consulting services for closely held private and public companies.

David has a specialized expertise in assisting companies in the franchise industry, and has served as a consultant, interim manager and financial advisor for turnarounds and workouts, restructurings and helping financially-distressed and underperforming companies achieve successful outcomes. David is a Certified Turnaround Professional (CTP) and is active in the Turnaround Management Association, Chicago chapter where he is currently a co-chairman of the CTP Committee. He can be reached at dbagley@morrisanderson.com.

AIRA Scholar in Residence

Professor Jack F. Williams, CIRA, CDBV
Mesirow Financial Consulting

TOUSA: THE IMPORTANCE OF REASONABLY EQUIVALENT VALUE IN FRAUDULENT TRANSFER LAW

The case of the *Official Committee of Unsecured Creditors of TOUSA, Inc. et. al. v. Citicorp North America, Inc. et. al.*[1] (the "Adversary") sparked extensive discussion and debate when the bankruptcy court issued its decision on October 30, 2009, finding against all lenders.[2] That discussion heated up again when District Judge Gold of the United States District Court for the Southern District of Florida issued a strongly-worded opinion quashing and rendering null and void the bankruptcy judge's opinion in the fraudulent transfer action against certain of the lenders.[3] Before Judge Gold were the questions of whether the payment to one of three groups of lenders constituted a constructive fraudulent transfer, whether this group of lenders acted in good faith, and whether this group of lenders was an appropriate transferee for fraudulent transfer liability, among other issues. Presently, another appeal of the same adversary (but involving the two remaining groups of lenders) is pending before District Judge Adalberto Jordan, who has asked for additional briefs from the parties which should assume the correctness of Judge Gold's decision.[4] Before Judge Jordan are the questions of whether the guaranties by, and grants of liens in assets of, certain operating subsidiaries (the "Conveying Subsidiaries")[5] of the parent are constructive fraudulent transfers, whether these defendants acted in good faith nonetheless, the appropriate remedies, and an interesting independent but related question of whether a tax refund constituted a preference avoidable under section 547 of Title 11 of the United States Code (the "Bankruptcy Code").

In this column, I first discuss the role of reasonably equivalent value ("REV") and then address the question of whether the operating subsidiaries in both appeals received less than a reasonably equivalent value in exchange for the property transferred or obligations incurred as required by section 548 of the Bankruptcy Code. The question of REV is often neglected by attorneys and experts. Solvency is interesting and complex. REV, however, is more mundane, but as Judge Gold reaffirmed, no less important. Let us see why that is the case in the analysis of complex commercial transactions under fraudulent transfer law.

Introduction to Fraudulent Transfers

A trustee, or debtorinpossession under a chapter 11 case, may avoid any fraudulent transfer.[6] The Bankruptcy Code recognizes two types of fraudulent transfers. The first type, commonly referred to as an actual fraudulent transfer, is a transfer made by the debtor with the actual intent to hinder, delay, or defraud its creditors.[7] With this type of transfer, the court's focus is exclusively on the actual intent of the debtor. In the second type, commonly referred to as a constructive fraudulent transfer, the debtor's intent is irrelevant.[8] Rather, the focus is on whether the debtor received less than a reasonably equivalent value in exchange for the transfer and whether the debtor was in a precarious financial condition as defined by the Bankruptcy Code.[9]

A trustee may also avoid any transfer by the debtor that an unsecured creditor with an allowable claim could avoid under state fraudulent transfer law.[10] Under section 544(b)(1) of the Bankruptcy Code, a trustee's cause of action rises and falls under state law; therefore, one must acquaint oneself with the elements of state fraudulent transfer law. Although the Uniform Fraudulent Transfer Act ("UFTA") is similar in many respects to section 548 of the Bankruptcy Code, some states such as New York still operate under the previous uniform law – the Uniform Fraudulent Conveyance Act ("UFCA"), and some states like Texas have adopted non-uniform amendments to the UFTA.

Section 548 of the Bankruptcy Code grants the trustee the power to avoid a fraudulent transfer accomplished with either actual or constructive fraudulent intent. Sections 548(a) and 544(b) of the Bankruptcy Code (incorporating state fraudulent transfer law) recognize the power of the trustee to challenge transfers or obligations incurred as fraudulent transfers. The fraudulent transfer is an infringement of the creditor's right to realize upon the available assets of its debtor. The law imposes a substantive prohibition: the debtor may not dispose of its property with the intent, actual or implied by law, of placing the property beyond the reach of its creditors. Although most commentators agree that one of the fundamental thrusts of fraudulent transfer law is to protect the unjust diminution of the debtor's estate, the authorities disagree about where the proper limits of fraudulent transfer law should be drawn.[11]

1 Adversary No. 08-01435-JKO in the Bankruptcy Court for the Southern District of Florida.

2 422 B.R. 783 (Bankr.S.D. Fla. 2009).

3 *3V Capital Master Fund, Ltd. v. Official Comm. of Unsecured Cred. of TOUSA, Inc.*, 2011 U.S.Dist. LEXIS 14019 (S.D.Fla. 2011).

4 Order dated February 15, 2011 in case 09-60589-CIV-Jordan.

5 The Conveying Subsidiaries were also co-makers on the promissory note.

6 11 U.S.C. §548.

7 11 U.S.C. §548(a)(1)(a).

8 11 U.S.C. §548(a)(1)(b).

9 11 U.S.C. §548(a)(1)(b)(i)&(ii).

10 11 U.S.C. §544(b)(1).

11 *See, e.g.,* Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 Vand. L. Rev. 829 (1985); David Gray Carlson, *Is Fraudulent Conveyance Law Efficient?*, 9 Cardozo L. Rev. 643 (1987); Frank R. Kennedy, *The Uniform Fraudulent Transfer Act*, 18 U.C.C. L.J. 195 (1986); Jonathan C. Lipson, *First Principles and Fair Consideration: The Developing Clash Between the First Amendment and the Constructive Fraudulent Conveyance Laws*, 52 U. Miami. L. Rev. 247 (1997); Marie T. Reilly, *The Latent Efficiency of Fraudulent Transfer Law*, 57 La. L. Rev. 1213 (1997); Emily Sherwin, *Creditors' Rights Against Participants in a Leveraged Buyout*, 72 Minn. L. Rev. 449 (1988); Kathyrn Smyser, *Going Private and Going Under: Leveraged Buyouts and the Fraudulent Conveyance Problem*, 63 Ind. L.J. 781 (1988); Paul M. Shupack, *Confusion and Policy and Language in the Uniform Fraudulent Transfer Act*, 9 Cardozo L. Rev. 811 (1987); Mary Jo Newborn Wiggins, *A Statute of Disbelief?: Clashing Ethical Imperatives in Fraudulent Transfer Law*, 48 S.C.L. Rev. 771 (1997); Jack F. Williams, *Revisiting the Proper Limits of Fraudulent Transfer Law*, 8 Bankr. Dev. J. 55 (1991); Jack F. Williams, *The Fallacies of Contemporary Fraudulent Transfer Models as Applied to Intercorporate Guaranties: Fraudulent Transfer Law as a Fuzzy System*, 15 Cardozo L. Rev. 1403 (1994); Barry L. Zaretsky, *Fraudulent Transfer Law as the Arbiter of Unreasonable Risk*, 46 S.C.L. Rev. 1165 (1995); Todd J. Zywicki, *Rewrite the Bankruptcy Laws, Not the Scriptures: Protecting a Bankruptcy*

TOUSA *continues from p. 5*

Lack of REV in Exchange for Property Transferred

Under section 548(a)(1)(B)(i) of the Bankruptcy Code, receiving less than a reasonably equivalent value for a transfer made or obligation incurred is one of the necessary elements of a constructive fraudulent transfer. The assessment of reasonably equivalent value is objective and is generally a question of fact.[12] Courts have generally employed a case-by-case approach in assessing reasonably equivalent value while observing the unfairness of applying mechanical tests.[13] Reasonably equivalent value is not susceptible to simple formulation. Ideally, it should signify the reasonable estimate of what can be realized from the debtor's assets by converting them into cash under possibly guarded (but not forced-sale) conditions. It is wrongheaded to think of reasonably equivalent value as a "number," or more correctly, a point estimate of value.[14] Rather, data on prices and market fluctuations suggest that a careful analysis of value must begin with an interval estimate of values that captures a more accurate and reliable picture of property, market, and value. Thus, value that falls short of a reasonably equivalent value is value that falls outside the range of values one would expect reasonable parties to reach based on the information available to each at the time of the transfer with both parties acting at arm's length. The value that is the fruit of ordinary business dealings, that is consistent with the ordinary business practices of others, and that is in the range of values one could reasonably anticipate strongly suggests a reasonably equivalent value.

Unlike the UFTA or the Bankruptcy Code, the Texas UFTA[15] does provide a noninclusive definition of reasonably equivalent value. Under Texas UFTA Section 24.004(d), reasonably equivalent value includes, without limitation, a "transfer or obligation that is within the range of values for which the transferor would have willfully sold the assets in an [arm's] length transaction."[16] This definition is consistent with the decision in *Anderson Industries, Inc. v. Anderson (In re Anderson Industries, Inc.)*,[17] which analyzed reasonably equivalent value in light of the fact that the bargained-for exchange was reached through arm's length negotiations where, presumably, the purchaser was the best informed party as to the value of the asset.[18] Thus, the value that is the product of less than an arm's length transaction, secret dealings, or extraordinary business practices, or falls outside the range of values one could reasonably anticipate strongly suggests a failure of a reasonably equivalent value. Any greater precision comes at the sake of clarity. Now, we turn to the case at hand.

Factual Background in TOUSA

The Adversary involved a complex set of facts in a specialized situation – rescue financing.[19] Thus, much of the courts' opinions must be understood in that specialized context and may not be cleanly imported to other traditional contexts fraught with fraudulent transfer concerns, such as leveraged buyouts, redemptions, distributions/dividends, equity carve outs, and divisive transactions like spin-offs, where equity seeks to monetize its investment, oftentimes at the expense of the unsecured creditors of the bankruptcy estate.

Prior to its bankruptcy filing, TOUSA, Inc., and its related entities ("TOUSA") constituted one of the largest publicly held homebuilders in the country, heavily involved in the Florida, Mid-Atlantic, Arizona and Nevada markets. Prior to the challenged transaction, TOUSA had nearly $1.1 billion in unsecured bond indebtedness (the "Bond Indenture") and an $800 million revolving credit facility, secured by substantially all of the TOUSA assets, which was used to fund operations (the "Revolver").[20] Both the bond debt and the Revolver debt were guaranteed by almost all of the operating subsidiaries.[21] TOUSA operated as a consolidated entity, with the parent company providing payroll, corporate and nearly all of the operational services to the subsidiaries. TOUSA made frequent use of joint venture structures to accomplish its acquisitions, ostensibly to keep the obligations incurred by the joint ventures remote from the rest of the TOUSA group.

One of TOUSA's joint ventures, the Transeastern joint venture ("TE") was formed between subsidiary TOUSA Homes L.P., and outside entity Falcone/Ritchi LLC[22] at the height of the Florida real estate market (June 2005). TE borrowed $675 million pursuant to various credit agreements from a group of lenders, with Deutsche Bank Trust Company Americas acting as the Administrative Agent (the "TE Lenders").[23] The TE obligations were originally proclaimed to be non-recourse; however, TOUSA, Inc. and TOUSA Homes L.P. executed completion and carve-out guaranties in connection with the TE debt. TE foundered nearly immediately as the Florida market declined.[24] TE was forced to announce an event of default under its credit agreements on September 27, 2006.[25] The TE Lenders subsequently made demands upon TOUSA, Inc. under the guaranties. Litigation resulted, with TOUSA, Inc. filing a declaratory action

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Debtor's Right to Tithe, 1998 Wis. L. Rev. 1223.

12 *See Klein v. Tabatchnick*, 610 F.2d 1043, 1047 (2d Cir. 1979); *Jacoway v. Anderson Cajun's Wharf (In re Ozark Restaurant Equip. Co.)*, 74 B.R. 139, 143 (Bankr. W.D. Ark.), *remanded*, 77 B.R. 686 (W.D. Ark.), *on remand*, 83 B.R. 591 (Bankr. W.D. Ark. 1987), *aff'd in part and rev'd in part*, 850 B.R. 342 (8th Cir. 1988); *but see BFP v. Resolution Trust Corporation*, 511 U.S. 531, 114 S. Ct. 1757 (1994)(bid price held to constitute reasonably equivalent value in noncollusive nonjudicial foreclosure sale); *Durrett v. Washington Nat'l Ins. Co.*, 621 F.2d 201, 203 (5th Cir. 1980) (question of law in mortgage foreclosure context).

13 *See, e.g., Adwar v. Capgro Leasing Corp. (In re Adwar)*, 55 B.R. 111, 115 (Bankr. E.D.N.Y. 1985); *see also Rubin v. Manufacturers Hanover Trust Co.*, 661 F.2d 979, 994 (2d Cir. 1981) (rejecting any requirement of "mathematical precision" in determining reasonably equivalent value); *but see Durrett*, 621 F.2d at 203 (observing that a foreclosure bid price of less than 70% of fair market value would not constitute reasonably equivalent value), *rejected in, BFP v. Resolution Trust Corporation*, 511 U.S. 531, 114 S. Ct. 1757 (1994).

14 *See* David S. Salsburg and Jack F. Williams, *A Statistical Approach to Claims Estimation in Bankruptcy*, 32 Wake Forest L. Rev. 1119 (1997).

15 Tex. Bus. & Com. Code Ann. §24.004(d) (Vernon).

16 *Id.; see Kjeldahl v. United States (In re Kjeldahl)*, 52 B.R. 926, 934 (Bankr. D. Minn. 1985) (reasonably equivalent value is the amount which reasonable minds would agree is a close or fair exchange given all the circumstances surrounding the transfer).

17 55 B.R. 922 (Bankr. W.D. Mich. 1985).

18 *Id.* at 927-28.

19 In fact, spelling out the parties and contentions in detail would render this article prohibitively long. Thus, please excuse my abbreviations—JW.

20 *Official Comm. of Unsecured Cred. v. Citicorp N.A.*, 422 B.R. 783, 787 - 790 (Bankr.S.D.Fla. 2009).

21 *Id.* at 787.

22 *Id.* at 787–788.

23 *Id.* at 788.

24 *Id.*

25 *Id.*

in Florida state court and the TE Lenders filing suit seeking repayment of the TE loans in New York state court (collectively, the "TE Litigation").[26] A judgment against TOUSA would have constituted a default under the existing Revolver and the Bond Indenture.

Sensing excessive exposure and liability in the actions surrounding TE, TOUSA elected to settle with the TE Lenders and to acquire the remaining TE assets. To finance this transaction, TOUSA entered into a financing agreement dated July 31, 2007 (the "July 31, 2007 Transaction"), to finance the settlement of the TE Litigation (the "TE Settlement") which is at the center of the fraudulent conveyance litigation. The July 31, 2007 Transaction credit agreements involved the following pieces:

- $200 million "First Lien Term Loan;"
- $300 million "Second Lien Term Loan;" and
- an Amended Revolving Credit Agreement (the "Amended Revolver") (which reduced the Revolver commitment from $800 million to $700 million).[27]

To secure these obligations, TOUSA, Inc. and its subsidiaries granted the First and Second Lien Term Loan lenders' liens on substantially all of the TOUSA assets.[28] It is important to note that certain of the operating subsidiaries (the "Conveying Subsidiaries") granted liens on their assets in support of the July 31, 2007 Transaction were not liable for the debts associated with TE.

Following the July 31, 2007 Transaction, TOUSA's health declined rapidly, mirroring the crash of the real estate market and drying up of the credit markets. TOUSA, Inc. and substantially all of its subsidiaries filed for chapter 11 bankruptcy protection on January 29, 2008, in the Bankruptcy Court for the Southern District of Florida. The Official Committee of Unsecured Creditors of TOUSA, Inc., *et. al*. (the "Committee") requested, and was granted, standing to pursue certain preference and fraudulent conveyance claims on behalf of the estate against: (1) First Lien Term Loan Lenders; (2) the Amended Revolver Lenders; (3) Second Lien Term Loan Lenders; and (4) TE Lenders. The Bankruptcy Court further entered an order allowing the Committee to use the First Lien Lenders' and the Second Lien Lenders' cash collateral to prosecute the litigation against them without imposing any cap or form of financial discipline.

Bankruptcy Court Opinion

After a thirteen day trial, the Bankruptcy Court determined that the obligations incurred and liens granted to the First and Second Lien Lenders were fraudulent transfers and the payment made to the TE Lenders was likewise a fraudulent transfer.[29] The Bankruptcy Court further found that the contemporaneous evidence and expert testimony showed that the Conveying Subsidiaries were insolvent at the time of the July 31, 2007 Transaction and that the transactions: (1) rendered them even less solvent, (b) left them with unreasonably small capital, and (c) left them unable to pay their debts as they matured.[30] In making this determination the Bankruptcy Court rejected the idea that solvency should be measured on a consolidated basis, noting that the intertwining of TOUSA's corporate group was "similar to the typical relationship between corporate parents and subsidiaries"[31] and that "TOUSA was a normal corporate structure."[32] The Bankruptcy Court also refused to enforce the savings clauses in the First and Second Term Loans, holding, among other things, that "the savings clauses are a frontal assault on the protections that section 548 of the Bankruptcy Code provides to other creditors" and therefore "they are… entirely too cute to be enforced."[33]

More relevant to this inquiry, the Bankruptcy Court also determined that the Conveying Subsidiaries did not receive reasonably equivalent value in exchange for the obligations and transfers.[34] The Bankruptcy Court rejected various direct and indirect benefits the Conveying Subsidiaries received as a result of the July 31, 2007 Transaction, holding that, since benefits did not fall within the Court's narrow definition of property, they were "legally irrelevant"[35] and therefore could not constitute reasonably equivalent value.[36] In summary, the Bankruptcy Court held that the Conveying Subsidiaries did not receive reasonably equivalent value for the incurrence of the upstream obligations and transfer of liens on their assets to secure the $500 million July 31, 2007 Transaction term loan financings used to fund the TE Settlement involving the parent.

As support for its rejection of REV, the Bankruptcy Court rested its decision on a parsing of the definition of value found in section 548(d) of the Bankruptcy Code and resorting to a dictionary definition of property that required some form of quantification.[37] The Bankruptcy Court held that the Conveying Subsidiaries received no "direct benefits" because they received no proceeds from any of the loans, could not use loans to satisfy their own debts, received no net value from assets received as part of the TE settlement, and received no tax benefits.[38] Furthermore, the Bankruptcy Court held that the Conveying Subsidiaries received no indirect benefits. It based this conclusion on three grounds. First, the Bankruptcy Court held that any indirect benefit must be to the debtor (in the singular) and not to the debtors or corporate enterprise as a whole.[39] Second, the Bankruptcy Court held that the definition of value under section 548(d)(2) of the Bankruptcy Code means either "property" or "satisfaction of a present or antecedent debt of the debtor"[40] and must have cognizable value.[41] Third, the Bankruptcy Court held that the value must be received "in exchange for" some transfer or obligation.[42]

Based on these conclusions, the Bankruptcy Court quickly dispensed with each indirect benefit claim proffered by the defendants. In response to the claim that the TE Settlement eliminated the cloud hovering over the TOUSA group because of the TE Litigation, the Bankruptcy Court observed that there existed no property right to the elimination of the cloud of litigation to which the Conveying Subsidiaries were not

26 *Id.* at 789.
27 *Id.*
28 *Id.* at 789–790.
29 *Id.* at 786.
30 *Id.*
31 *Id.* at 834.
32 *Id.*
33 *Id.* at 864.
34 *Id.* at 865.
35 *Id.* at 868.
36 *Id.*
37 *Id.* at 868–869.
38 *Id.* at 844 - 845.
39 *Id.* at 868.
40 11 U.S.C. § 548(d)(2)(A).
41 422 B.R. at 868-869.
42 *Id.* at 869.

TOUSA continues from p. 7

party.[43] In response to the claim that the TE Settlement forestalled the bankruptcy of the TOUSA parent, the Bankruptcy Court found that the continued use of preexisting corporate services was not "value" received "in exchange for" the TE Settlement and that TOUSA continued providing corporate services after declaring bankruptcy.[44] In response to the claim that the TE Settlement forestalled the bankruptcy of Conveying Subsidiaries, the Bankruptcy Court found that avoiding bankruptcy was not a "property" interest and that the Conveying Subsidiaries could have avoided bankruptcy by using unencumbered assets to secure financing.[45] Consequently, the Bankruptcy Court held that because the Conveying Subsidiaries did not receive property or satisfaction of a present or antecedent debt, they did not receive value.[46] Because they received no value, it was impossible for them to receive reasonably equivalent value from the TE Settlement.[47]

District Court Opinion

In an unusually forceful opinion, District Court Judge Gold quashed the Bankruptcy Court's opinion.[48] As it relates to the REV analysis, Judge Gold rejected the Bankruptcy Court's REV analysis and conclusions across the waterfront. Initially, Judge Gold held that the Bankruptcy Court incorrectly assigned the burden of proof to the defendants to show indirect benefits that were tangible and concrete, and of quantifying the value of those benefits with reasonable precision.[49] According to the District Court, under established case law, "the burden of proving lack of 'reasonably equivalent value' under [Section 548(a)(2)(A)] rests on the trustee challenging the transfer."[50]

Second, Judge Gold addressed the Bankruptcy Court's narrow definition of property. The Bankruptcy Court had held that "…as a matter of natural usage, legal usage, and bankruptcy-law usage, the Conveying Subsidiaries could not receive 'property' unless they obtained some kind of enforceable entitlement to some tangible or intangible article."[51] According to the Bankruptcy Court, to the extent that the Defendants' claims of indirect benefits rest on the avoidance of default and bankruptcy by the Conveying Subsidiaries, those claims are equally flawed. Thus, according to the Bankruptcy Court, "avoiding default" is not "property" and therefore is not cognizable as "value" under the statute.[52]

The District Court rejected the narrow construct of the meaning of property employed by the Bankruptcy Court.[53] The District Court held that the:

> Bankruptcy Court's narrow dictionary definition of property is contrary to the meaning of the term in the Bankruptcy Code. The legislative history for the Bankruptcy Reform Act of 1978 provides that "[a]lthough 'property' is not construed in [Section 102 of the Code], it is used consistently throughout the Code *in its broadest sense*, including cash, all interests in property, such as liens, *and every kind of consideration* including promises to act or forbear to act as in section 548(d)."[54] [emphasis in original]

The District Court then held that the Bankruptcy Court committed legal error in holding that the "avoidance of default and bankruptcy by the Conveying Subsidiaries is, as a matter of law, not property and therefore is not cognizable as 'value' under" section 548 of the Bankruptcy Code."[55]

Third, Judge Gold turned to the question of whether intangible benefits could constitute value. Initially, he noted that the Eleventh Circuit has not yet had the opportunity to consider the application of the "reasonably equivalent value" test to the intricacies and complexities of the factual circumstances like the July 31 Transaction at issue.[56] The District Court observed that other circuits, such as the Third Circuit, have rejected the notion that a debtor must receive a direct, tangible economic benefit in order to receive "value" for purposes of Section 548(a)(2) of the Bankruptcy Code. The District Court held that the weight of authority supports the view that indirect, intangible, economic benefits, including the opportunity to avoid default, to facilitate the enterprise's rehabilitation, and to avoid bankruptcy, even if it provided to be short lived, may be considered in determining reasonable equivalent value.[57] Specifically, the District Court held that an expectation, such as in this case, that a settlement which would avoid default and produce a strong synergy for the enterprise, would suffice to confer "value" so long as that expectation was legitimate and reasonable.[58]

Fourth, Judge Gold addressed the question of whether steps taken by the Conveying Subsidiaries to attempt to avoid their common parent's bankruptcy constituted value under section 548 of the Bankruptcy Code.[59] The District Court was troubled by the apparent hindsight employed by the Bankruptcy Court. The Bankruptcy Court held that as a threshold matter, the evidence showed that the July 31 Transaction did not in fact prevent the bankruptcy of the parent company. Moreover, the Bankruptcy Court held that there was no reason to believe that the replacement of a contingent litigation liability with a massive amount of secured debt rendered TOUSA *better* able to weather the extreme downturn in the housing market. Thus, according to the Bankruptcy Court, because the July 31 Transaction did not prevent the parent's bankruptcy — at most it delayed the inevitable — it could not have given rise to any purported benefits to the Conveying Subsidiaries predicated on the avoidance of such a bankruptcy.

The District Court observed that the Bankruptcy Court improperly reviewed

43 *Id.* at 868.
44 *Id.*
45 *Id.*
46 *Id.* at 869.
47 *Id.*
48 *3V Capital Master Fund, Ltd. v. Official Comm. of Unsecured Cred. of TOUSA, Inc.*, 2011 U.S.Dist. LEXIS 14019 (Bankr.S.D.Fla. 2011).
49 *Id.* at 103.
50 Id. at 103. (Citing *In re Chase & Sanborn Corp.*, 904 F.2d at 593-94 (citing *Gen. Elec. Credit Corp. v. Murphy (In re Duque Rodriguez)*, 895 F.2d 725,726 n.1 (11th Cir. 1990)).
51 422 B.R. at 868 (Bankr.S.D.Fla. 2009). *See* Webster's Third New Int'l Dictionary 1818 (1986) (defining "property" in its broadest sense as "something . . . in which or to which a person has a right protected by law"); 11 U.S.C. § 541(a)(1) (defining "[p]roperty of the estate" to include "all legal or equitable interests of the debtor in property as of the commencement of the case") (emphasis added); *see also Bracewell v. Kelley (In re Bracewell)*, 454 F.3d 1234, 1239 (11th Cir. 2006) (debtor's "hope to an entitlement" not a property interest until it is legally cognizable.)."
52 422 B.R. at 868.
53 *3V Capital Master Fund, Ltd. v. Official Comm. of Unsecured Cred. of TOUSA, Inc.*, 2011 U.S.Dist. LEXIS 14019, 109 – 110.
54 *Id.* at 103. (Citing Statements by Legislative Leaders, 124 CONG. REC. 11,089 (1978), *reprinted* in 1978 U.S.C.C.A.N. 6439, 6508.)
55 *Id.* at 104-105.
56 *Id.* at 120–121.
57 *Id.* at 123–124.
58 *Id.*
59 *Id.* at 134–137.

the TE Settlement through the lens of retrospection by pointing out that the bankruptcy of the TOUSA group ultimately was not avoided.[60] However, whether a debtor received reasonably equivalent value must be evaluated as of the date of the transaction.[61] The District Court was further troubled by what it perceived as the cavalier treatment by the Bankruptcy Court of the fact that a parent bankruptcy would have constituted a default on TOUSA's Bond Indenture and under the Revolver, thereby allowing the bondholders to demand immediate payment on the Bond Indenture from the Conveying Subsidiaries.[62] The District Court rejected the Bankruptcy Court's finding that disastrous harm to the Conveying Subsidiaries was "not necessarily" inevitable absent the July 31 Transaction but "could" at least possibly be averted as speculative, based on no evidence in the record, and a product of hindsight.[63] The District Court found support for its treatment of this issue from the facts that the only evidence referenced by the Bankruptcy Court in support of the finding that the Conveying Subsidiaries could have obtained alternative standalone financing was the conclusory testimony of two of the Committee's experts. The District Court held "…that their testimony can only be characterized on appellate review as rank speculation."[64] Their opinions were predicated on their claim to have seen other subsidiaries survive bankruptcies of their parents, or negotiate around bond defaults, or obtain independent financing. Neither of these opinions was tied to, or addressed, the specific circumstances of this case.[65]

Fifth, District Judge Gold found that an attempt to avoid a subsidiary bankruptcy could also constitute value.

By virtue of the Transeastern Settlement, the Conveying Subsidiaries' "net worth" was preserved and imminent default was avoided, thereby preserving, at that point of time, the interests of the Committee's unsecured creditors by allowing the enterprise to continue to meet its bond interest obligations and Revolver loan payments. As such, additional Revolver payments were paid out in excess of $65 million following the Transeastern Settlement that allowed the enterprise's business to continue until the real estate industry totally collapsed later that year in a manner that was not foreseen at the time of the settlement.[66]

Finally, Judge Gold held that in addition to erring in its legal definition of value, and in its determination that the Conveying Subsidiaries did not receive value in the transaction, the Bankruptcy Court further legally erred by not considering the "totality of the circumstances"[67] in measuring reasonable equivalency. The District Court noted that "[t]his test as adopted by the Third Circuit in *In re R.M.L., Inc.*, has been applied in this Circuit by U.S. District Courts and U.S. Bankruptcy Courts in Florida.[68] Thus, the Court noted that:

> [u]nder such circumstances, no further proof of "quantification" was required to establish reasonably equivalent value, and the Bankruptcy Court further erred as a matter of law in requiring the same. Even the Committee concedes in its brief that "courts *sometimes can*, without precise mathematical quantification, decide that particular facts and circumstances show that a debtor received reasonably equivalent value." [Committee's Br., p. 109 (emphasis in original)]. Thus, a per se rule, as applied by the Bankruptcy Court, that indirect benefits must be mathematically quantified is error.[69]

Analysis of "Value" in TOUSA

"Value" is defined as "property, or satisfaction or securing of a present or antecedent debt of the debtor, but does not include an unperformed promise to furnish support to the debtor or to a relative of the debtor."[70] Here is where the Bankruptcy Court got it wrong, and the District Court correctly captured the statutory language and purpose. Under section 548(d)(2) of the Bankruptcy Code, value means property and the satisfaction of an antecedent debt. Both attributes of value were present in the case and dismissed or ignored by the Bankruptcy Court. Although value is defined, property is not. This is interesting. A quick perusal of the Bankruptcy Code would show that the term "property" is used over sixty times. Why would such a ubiquitous term be undefined in the Bankruptcy Code? One may quickly embrace the proposition that the term should receive its plain meaning, but the Bankruptcy Code is replete with defined terms such as "transfer" or "person" that also have plain meanings. It must be more than that. Maybe, one can assert, that property should be defined by incorporation of state law, the common juridical repository for property rights; thus, a federal definition would be at cross-purposes with that well-recognized theme. That too would be incorrect; since the Supreme Court's pronouncement in *Chicago Bd. Of Trade v. Johnson*,[71] it is settled law that the question of property in bankruptcy is a federal question. Thus, notwithstanding the fact that both the Illinois legislature and the Illinois Supreme Court had declared that a seat on the Chicago Board of Trade did not constitute property, the United States Supreme Court held that the seat was property of the bankruptcy estate.

The answer lies in the role property plays in the bankruptcy process. Property of the estate includes all the debtor's legal or equitable interests in property whether tangible or intangible.[72] It is this property that is used to satisfy the allowed claims of creditors in accordance with the distributional scheme in bankruptcy, either through a distribution under section 726 of the Bankruptcy Code in a chapter 7 case or a confirmed plan in a chapter 11 or 13 case. The use of the term property throughout the Bankruptcy Code does not require as a precondition to its recognition, any notion of quantification. In fact, the legislative history to both sections 541 (property of the estate) and 548(d)(2) (value for fraudulent transfer purposes) of the Bankruptcy Code reject such a qualification. Reading both sections together, it is clear that property is anything that is subject to ownership and value is anything that enhances the financial position of the debtor.[73] Moreover, if one was enticed to look outside of the Bankruptcy Code for a definition of property, rather than resort to the dictionary, a court may want to consider

60 *Id.* at 143–144.
61 *Id.*
62 *Id.* at 146–147.
63 *Id.* at 148.
64 *Id.* at 151.
65 *Id.* at 151.
66 *Id.* at 140.
67 *Id.* at 128-129.
68 Id. at 129.
69 *Id.* at 129.
70 11 U.S.C. §548(d)(2)(A).
71 246 U.S. 1 (1924).
72 11 U.S.C**.** §541(a)(1).
73 Report of the Commission on the Bankruptcy Laws of the United States Part II 147 – 151, 175-176, 178 n.10.

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the UFTA, which was enacted in Florida, the venue of the TOUSA bankruptcy cases. Unlike the Bankruptcy Code, the UFTA actually defines property in section 1 (10) "'Property' means anything that may be the subject of ownership." The offical comment further refines property by stating that the term includes "both real and personal property, whether tangible ot intangible, and any interest in property whether legal or equitable."[74] Noticeably absent from the defintions of value under the Bankruptcy Code or the UFTA, and the use or definition of property under the Bankruptcy Code or UFTA, is any qualification that property must be quantifiable. The Bankruptcy Court mistake in insisting on a qualification that does not exist under either the Bankruptcy Code or the UFTA is understandable, however. What the Bankruptcy Court did was replace the term "property" with the Generally Accepted Accounting Principles ("GAAP") concept of "asset," not an uncommon mistake. Under GAAP, assets are "probable future economic benefits obtained or controlled by an entity resulting from past transactions or events."[75] One of the foundational principles found in Financial Accounting Standards Board ("FASB") that serves as part of the entire architecture of GAAP is the "monetary transactions principle." This principle requires that for transactions to be reported, they must be capable of measurement in monetary terms based on some actual transaction. Thus, under GAAP, an asset must be quantifiable to be reported as such on the balance sheet. There is no such requirement for the concept of property and, thus, value under the Bankruptcy Code or the UFTA.

Reasonably equivalent value as commonly understood suggests a comparison of the property transferred by the debtor with the value actually received by the debtor.[76] But the comparison does not end the process. The bargaining position of the parties, the existence of an arm's length transaction, the parties' relationship, the adequacy of the price, the prevailing market conditions, and the marketability of the property transferred are all relevant considerations.[77]

Based on a careful distillation of the cases, it does appear that several important foundational themes regarding reasonably equivalent value may be identified and developed. First, courts consider REV from the perspective of the creditors of the debtor.[78] Second, courts will consider any insider status of the transferee and whether actual intent may be imputed to debtor through those entities that control the debtor.[79] Third, courts do compare what a debtor has received in exchange for what a debtor has transferred. However, reasonable equivalent value is not synonymous with fair market value, although the latter may be a factor.[80] Fourth, courts consider a totality of the circumstances in addition to a value comparison, including earmarks of an arm's length transaction, that the transferee acted in good faith, and the degree of difference between the fair market value of property transferred to the value received.[81] Finally, indirect benefits may be considered, for example preservation of net worth or the going concern value of an enterprise, even where the net worth is ultimately unaffected.[82]

Observations

Based on a proper reading of the terms value and property under section 548(d)(2)(A) of the Bankruptcy Code and an understanding of the role those concepts play, Judge Gold presented a more compelling analysis of the presence of a reasonably equivalent value in exchange for the transferring of liens by the Conveying Subsidiaries as part of the TE Settlement. The REV present included (1) benefits derived from the TE Settlement that allowed the TOUSA Group to remain a vital enterprise after the TE Settlement, thus preserving the going concern value; (2) benefits derived from the settlement of TE Litigation in which the Plaintiffs asserted damages in excess of $2 billion against TOUSA; and (3) specifically identified and valued benefits for the TE Settlement.

Specifically, in the Category 1 benefits, the Bankruptcy Court should have considered that any judgment entered against TOUSA in an amount exceeding $10 million in the TE Litigation, would have resulted in a default under the $1.06 billion of TOUSA Bond Indenture, which could have led to acceleration of such Bond Indenture and a chapter 11 filing for TOUSA because it would be unlikely that TOUSA would have been able to refinance that debt on a timely basis. Further, such a judgment would have also caused a default under the Revolver, on which the Conveying Subsidiaries were co-borrowers and on which they relied for cash and for letters of credit. Avoiding such defaults was benefit to the Conveying Subsidiaries. Further, a bankruptcy filing by TE would have likely adversely affected the value of TE's assets and would have had a material impact on TOUSA's operations, triggering the Carve-Out guaranties. Based in part on a report prepared by a reputable investment banking firm contemporaneous with the transactions, the TOUSA Group determined that it would remain a viable enterprise after the TE Settlement, thus preserving the going concern value of approximately $200–$600 million in excess of all indebtedness. The TOUSA Group determined that the TE Settlement represented a substantial return to unsecured creditors (an estimated 100% return plus interest) as compared to a projected recovery in a hypothetical chapter 11 case of substantially less at the time of the TE Settlement. Thus, by executing the TE Settlement, both the parent and the Conveying Subsidiaries attempted to preserve their going concern value and net worth by attempting to stave off a series of defaults, ultimate bankruptcy, and an erosion of asset value.

In the Category 2 benefits, value would have included the settlement of the TE Litigation for substantially less than the $2 billion alleged. Moreover, the TE Settlement resulted in the release of TE from $70 million in potential earn-out and entitlement payments; of TOUSA from all claims for terminated properties ($145 million); of TOUSA from all claims under the Completion Guaranties for terminated properties deemed to be no longer financially viable; of TOUSA

74 7A Part II ULA §1, Official Comment 10.

75 Statement of Financial Accounting Concepts 6 – FASB.

76 *See* 1A Bankr. Serv. L. Ed. §5D:45, at 42.

77 *See also Jacoway v. Anderson (In re Ozark Restaurant Equip. Co.)*, 850 F.2d 342, 345-346 (8th Cir. 1988) (analysis of reasonably equivalent value in fraudulent transfer context requires consideration of all relevant circumstances including market conditions).

78 *See generally In re Prejean*, 994 F.2d 706 (9th Cir. 1993).

79 *Schempp v. Lucre Mgmt Group, LLC*, 18 P.3d 762, 765 (Colo. App. 2000).

80 *Id*.

81 *Brandt v. Trivest II, Inc. (In re Plassein)*, 405 BR 402, 411 (Bankr. D. Del. 2009).

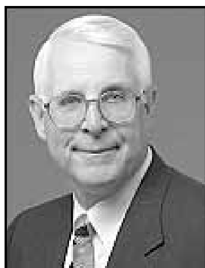
82 *Wells v. Sleep (In re Michigan Machine Tool Control Corp.)*, 381 BR 657, 669 (Bankr. E.D. Mich. 2008); *SEC v. Resource Dev.*, 487 F.3d 295 (5th Cir. 2007).

from on-going monthly option payments and property carry costs of $40 million annually; and of TOUSA from option land purchase payments of $160 million on terminated properties.

Finally, in the Category 3 benefits, value would have included the receipt by the entire TOUSA group, including the Conveying Subsidiaries, of certain present and future tax assets. TOUSA was able to monetize tax assets, resulting in a tax refund attributable to the TE Settlement in excess of $54-$61 million.[83] Moreover, TOUSA obtained the present value of future tax benefits in excess of $38-$45 million. Additionally, the TE Settlement resulted in a reduction of indebtedness. The Mezzanine lenders of TE converted existing TE loans into new debt and equity at TOUSA valued at $153.75 million, which represented a 31.7% discount from the face value of $225 million ($71.25 million reduction in principal) of the debt. Moreover, TOUSA did not pay Senior and Junior Mezzanine lenders $34.3 million in accrued interested. Furthermore, the TOUSA Group obtained TE net assets of approximately $160 million through the TE Settlement.

Based on a functional reading of the definition of value and the development of the current state of the law on what constitutes reasonably equivalent value, Judge Gold concluded that the value received by the Conveying Subsidiaries for the TE Settlement in the context of an arm's length transaction□where the debtors had consulted with an investment banker, a Big Four accounting firm, a valuation and restructuring advisor, and a prominent international law firm on available options□constituted a reasonably equivalent value for the property transferred in the form of the granting of liens and the obligations incurred. Judge Gold's opinion is a compelling analysis of the importance of REV in a fraudulent transfer action and the need to push beyond simple value comparisons to assess whether REV is present. I am sure we will hear more on the subject in the months and possibly years to come. ■

83 The ability to control the timing of sustaining the losses permitted the TOUSA consolidated tax group to carryback losses to the two preceding tax years and reduce the tax obligations, a debt owed by all members of the consolidated group (including the Conveying Subsidiaries), and thus constituted value even under the more restrictive definition employed by the Bankruptcy Court. Specifically, under the Consolidated Return Regulations, each member of the consolidated group became severally liable for the income tax of the entire group. Treasury Regulation §1.1502-6. Thus, TOUSA as parent and all Conveying Subsidiaries as members of the consolidated group could use the group's tax attributes, including losses, to offset any income, thus reducing the overall tax liability of the group.



Bankruptcy Taxes

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A LOOK INSIDE THE BLACK BOX: IRS MANUAL ON PROCEDURES FOR BANKRUPTCY CASES

Even to long term tax practitioners, the inner workings of the IRS are somewhat of a black box we only see the end results. However, the IRS is guided by a procedures manual, many portions of which are public and are sometimes interesting to read. I should also note that having worked with IRS agents for 35 years, I can tell you that the IRS, like most other organizations, does not always operate by the book. The IRS division known as "Small Business/Self Employed Persons" recently released an update on their procedures for bankruptcy cases. Those procedures are based on the type of case.

Chapter 7 Cases

Generally the IRS specialist must complete an initial case analysis in a case assigned to Field Insolvency at least five calendar days prior to the scheduled 341 meeting date. At minimum, when conducting the initial case analysis, the specialist must determine the following, where applicable:

Are there any outstanding liabilities that are potentially dischargeable?

Are there any circumstances present that indicate that the debtor may have attempted to willfully evade the payment of the taxes?

Are there any badges of tax or bankruptcy fraud present?

Does the debtor have any exempt, abandoned or excluded property available for collection after the discharge?

Is attendance at the 341 meeting to question the debtor warranted in the case?

Are there violations of the stay to be addressed?

If the debtor is a serial filer, is the automatic stay in the current case impacted by the filing of previous bankruptcy petitions?

Is there a Notice of Federal Tax Lien (NFTL) present that requires refiling?

Is a referral to IRS Counsel needed to object to the discharge?

Is assertion of the Trust Fund Recovery Penalty (TFRP) [unpaid payroll taxes—FL] required in the case?

Chapter 11Cases

As in the Chapter 7 cases, an initial analysis must be completed at least 5 days before the 341 meeting and attendance at the 341 meeting is encouraged. These are some of the considerations the specialists are to use in the analysis:

Federal trust payroll taxes Status of federal employer payroll withholding taxes and the feasibility of assessing against an officer of the corporation.

Exam Issues. IRM 5.9.4.3, *Examination and Insolvency*, provides guidance for addressing examination issues including abusive tax avoidance transactions and employee plans.

Refund Issues. The caseworker must ensure the correct bankruptcy freeze code has been placed on the account and check

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for the presence of a "quickie" refund request.

Stay Violations. The caseworker must identify potential stay violations, be they liens recorded postpetition, levy proceeds received after the petition date, or notices sent in violation of the stay.

Employee Leasing. The caseworker must determine if employee leasing relationships exist. This is when the business purportedly transfers some or all of its employees to another entity that leases them back to the original employer.

Subsidiaries or Parent Company. The caseworker must determine if the entity is a subsidiary of a parent company or is a parent company with subsidiaries. Subsidiary refunds or liabilities must be noted in the AIS history. Difficult setoff issues arise when refunds are owed to members of consolidated groups. If a refund is owed to a group or some of its members, and members of the group also owe liabilities, Insolvency should consult Counsel regarding the Service's setoff rights.

Prepackaged Chapter 11. The caseworker must determine if the case is a prepackaged bankruptcy which is a plan of reorganization in which the debtor solicits the creditors' approval prior to the filing of the bankruptcy petition. If the plan has been prepackaged and the Service was not part of the negotiations, the caseworker must secure a copy of the plan, review it expeditiously, and consult Counsel

Notice to Employee Plans function. To protect the integrity of employee plans of businesses that have declared bankruptcy, Insolvency must notify the Employee Plan (EP) function that a Chapter 11 bankruptcy meeting "significant case" criteria is filed or a nationally known company has filed bankruptcy even though that company may not have a tax liability.

Significant Cases and Referrals to Counsel. *[aka major red flags—FL]* cases meeting the Significant Bankruptcy Case Program criteria must be referred to IRS Counsel. Here are some highlights:

The debtor has a $100 million or more in gross assets.

The debtor files a motion to restrict or prohibit the sale or other disposition of its stock or files a motion to sell or otherwise dispose of a significant or material portion of its assets for consideration other than cash.

The plan provides for a significant delay between plan confirmation and debt discharge (for example, debts are discharged after the close of the tax year when plan confirmation occurs).

The plan provides for the creation of a liquidating trust and the terms of the plan do not conform to the requirements for a liquidating trust in Revenue Procedure 94-45.

The disclosure statement or plan indicates that there are foreign tax claims against the debtor. ■

Thanks to Grant Newton and Dennis Bean for their assistance.

IRS TO SCRUTINIZE REORGANIZATION PLANS INCLUDING FOREIGN COMPANIES

In 2004 Congress enacted Internal Revenue Code Sec. 7874 to discourage U.S. corporations from "expatriating," or moving offshore to escape American income taxation, known as "inversion" transactions. The law applies when there is a stock or asset transfer from a U.S. company to a legal entity established in a foreign country that has 60% or more identity of ownership with the transferor. The foreign entity is referred to as a "surrogate foreign company." In transactions that run afoul of the rule, the purported transfer to the "surrogate foreign company" is basically ignored and the income of the foreign company is subjected partly or fully to U.S. federal income tax.

In a recent IRS letter ruling, 201105022, the IRS Office of Chief Counsel, International, advised the IRS Bankruptcy Coordinator for Large and Middle Size Businesses to require that any Plan of Reorganization which involves the formation of new foreign entities to not only make representations that the new entity is not a "foreign surrogate company" but also to explain why in detail.

Commentary: Those involved in drafting a Plan of Reorganization involving foreign companies which are intended to be outside the U.S. tax system would do well to elaborate in the Plan just why their transaction is not an "inversion transaction" which would be subject to continued U.S. federal income taxation. ■

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

RARE INJUNCTION UPHELD AGAINST IRS IN AMBAC

Ambac Financial Group is the New York parent company of the Ambac Assurance Corporation, a Wisconsin insurance company. For many years Ambac served primarily as one of the largest municipal bond insurers. Some years ago, Ambac perceived an opportunity for higher returns by writing insurance policies to backstop collateralized debt obligations ("CDOs", enabling the CDOs to obtain higher credit ratings. When many investors started filing claims on defaulting CDOs during the sub-prime meltdown, the parent, Ambac Financial Group, was eventually forced to file a petition in Chapter 11 on November 8, 2010.

As Ambac slid into financial trouble during early 2010, the Wisconsin insurance commissioner decided to implement a rehabilitation program of the ailing part of the business of the insurance subsidiary and, as authorized under that state's law, ordered that the troubled policies be placed in a segregated account to isolate them from the solvent policies. The Plan of Operation approved by the Wisconsin county court provided that about 1,000 out of Ambac's 15,000 policies had material projected losses, structural problems with the underlying transactions and contractual triggers that could not be avoided except by court action, and that they be assigned to the "segregated account," while keeping the remainder in Ambac's general account. The segregated account has no claim-paying assets of its own, but is capitalized by a two-billion dollar secured note issued by Ambac to the account and an aggregate excess loss reinsurance agreement provided by Ambac.

Tax Problems

Since Ambac files a consolidated federal income tax return, all tax matters are handled by the parent holding company

which filed the petition in Chapter 11, but every member of the corporate group remains "severally" liable for the tax. Although the insurance subsidiary did not file a petition but was being reorganized in the state proceeding, the insurance company remained on the hook for the federal income tax because of the "several" liability. When the consolidated group, primarily the insurance company, incurred tax net operating losses between 2008 and 2010, those losses were carried back to profitable years to obtain "tentative" tax refunds of at least $700 million under the various relief provisions enacted during that period. Some of it was obtained by Filing Form 1139 for quick refunds under IRC Sec. 6411. The intent of that section is that the IRS issue the refund within 90 days; the IRS then audits suspicious refund claims after the fact. In October 2010 the IRS commenced an audit and one finding was that Ambac had made an unauthorized accounting method change to reduce the tax . The result was that the IRS demanded the return of $700 million, which helped to precipitate the Chapter 11 petition on November 8, 2010. One of the first motions Ambac made was for the bankruptcy court to determine its tax liability. More importantly, with the approval of the insurance commissioner, Ambac allocated its tax liability to the segregated account and obtained an injunction against the IRS in Wisconsin state court preventing the IRS from "initiating any type of lawsuit in regard to Ambac's potential federal tax liabilities in any court, administrative body or other tribunal against the segregated account."

IRS Reaction

Understandably, the Internal Revenue Service was very upset at this tactic, calling it "completely unprecedented" in view of the longstanding federal law against enjoining the IRS from collection of taxes. The Tax Anti-Injunction Act, originally enacted in 1867 and currently codified at 26 U.S.C. § 7421(a), provides that generally "no suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court by any person, whether or not such person is the person against whom such tax was assessed." This rule essentially requires that a person resisting the assessment of a tax must first pay the tax asserted and then file a formal administrative claim for refund with the IRS. As a general rule, the courts will not entertain a suit to enjoin the government from assessing the tax, but will entertain a suit for a tax refund after the IRS has denied the refund claim, or six months have elapsed (120 days in bankruptcy cases) since the filing of the claim, whichever is earlier.

Federal Court Action

The Internal Revenue Service filed suit in the U.S. District for Western Wisconsin to have the tax matter removed to federal court jurisdiction, which was opposed by the Wisconsin insurance commissioner. In February 2011 the federal judge twice upheld the state jurisdiction and has refused to lift the injunction, primarily relying on a federal law, the McCarran-Ferguson Act of 1945, which leaves insurance regulation to the states. In her opinion Judge Crabb stated:

> Contrary to the United States' argument, the McCarran-Ferguson Act does not exempt federal tax laws from its prohibition. It is true that under the Anti-Injunction Act…no state law or state court can restrict the assessment or collection of taxes… However, it does not follow that federal law in the form of the McCarran-Ferguson Act cannot override this statute and any others insofar as they threaten to impede or impair the state's regulation of the business of insurance. As the Court of Appeals for the Seventh Circuit has recognized, the McCarran-Ferguson Act overturns the ordinary preemptions rules by imposing a rule that state laws enacted for the purpose of regulating the business of insurance do not yield to conflicting federal statutes unless the federal statute specifically provides otherwise.

The judge pointed out that the injunction does not really prevent the IRS from ultimately collecting tax from the taxpayer; it merely requires the IRS to stand in line with other creditors in the rehabilitation process. In the opinion, the court likened the state rehabilitation proceeding of the insurance company to a federal bankruptcy and imputed an automatic stay similar to that in a federal bankruptcy. Judge Crabb also cited reasons of state sovereignty for her opinion.

Commentary

Because of the involvement of a state regulated insurance company this case presents unusual facts, but it is an interesting example of the rare situation in which an injunction preventing the IRS from moving immediately with all its powers to collect taxes was upheld.

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

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RALPHS GROCERY: TOUGHER ROAD AHEAD FOR SOME TYPE G REORGANIZATIONS?

Sometimes taxpayers or the IRS get on the "wrong" side in a case and it can make for contrarian and far reaching results. In the recent case of *Ralphs Grocery Co. v. Commissioner* (T.C., No. 20364-06, T.C. Memo. 2011-25, 1/27/11), the taxpayers pursuant to a confirmed Chapter 11 plan of bankruptcy reorganization thought they had a good taxable reorganization (sale) but the IRS contested, arguing that it was a nontaxable corporate reorganization under IRC Sec. 368. As explained in an article in the February-March, 2010, issue of *AIRA Journal*, in some bankruptcy reorganizations a taxable transfer of assets to the creditors is the best way to preserve favorable tax attributes especially increased basis for depreciation in the assets, as opposed to a taxfree reorganizationusually a Type G taxfree reorganization, in which asset basis remains unchanged.

Background

Ralphs Grocery Co., a California based retailer, was a small part of the very large U.S. consolidated tax return group of Federated Stores, Inc., which also contained other large, well known retailers such as Kroger, Fred Meyer and Allied Stores Corp. After a long and complicated series of transactions within the group and outside borrowings in the late 1980s, all of the corporate stock of Ralphs Grocery Co. was owned by two higher tier group members, a company called Holdings III and a company called Allied Stores Corp. The outside lenders were primarily the Ed DiBartolo Corp. and various banks. The stock of Ralphs, which was solvent at all times, was pledged toward the outside debt. In late 1989, two major members of the group, Allied and Federated, began to default on debt obligations. Although some members of the group remained

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solvent, Allied and Federated filed petitions in Chapter 11 on January 15, 1990, and the cases were immediately consolidated. The entire series of transactions is long and complicated but this article focuses on a narrow part of that series, skipping over many details that are not germane to the tax issue I want to highlight.

Chapter 11 Plan of Reorganization

One small part of the plan, effective as of February 2, 1992, required the transfer of the assets of Ralphs Grocery Co. to the bank lenders with no consideration going to its former common shareholders. The final version of the Plan provided that the transfer be structured as a sale for tax purposes which would allow the "step up" of the tax basis of the company's assets essentially to fair market value. This permits higher future depreciation and amortization tax deductions. Though the sale created a taxable gain to the old Federated Stores, Inc. group, Federated had net operating loss deductions to offset the taxable gain. Specifically the sale was to be consummated by merging the old Ralphs Grocery Co. into a new corporation which assumed the same name and whose stock was then transferred to the various lenders, 93% going to the outside lenders. The sale was treated by the parties under a special election, IRC Sec. 338(h)(10), for sale of stock of a target corporation from one corporate shareholder to an acquiring corporation which does not require the sale of individual assets but treats the stock sale as a "deemed" asset sale, resulting in a step-up in basis of the assets. The Federated group treated the lenders as the purchasers and the old Ralphs Grocery Co. as the "target." The Ralphs election included recognition of deemed goodwill of $600 million which is amortizable for tax purposes.

Sale treatment vs. Type G Tax-free Reorganization

Since no net tax was generated by the taxable gain on sale of $335 million recognized by the Federated group because of their net operating loss carryforwards and the assets in the hands of the creditors were stepped up by that same amount, it was a lose-lose situation for the Internal Revenue Service. The IRS looked at the transaction and took the position that it was not a valid IRC 338(h)(10) election but defaulted into a Sec. 368 taxfree reorganization, probably Type G (368(a)(1)(G)) for bankruptcy reorganizations. The requirements for a nontaxable Type G reorganization are: 1) a transfer by a corporation of all or part of its assets to another corporation in a Title 11 or similar case, and 2) continuity of interest on the part of the transferors. The IRS cited a 1942 Supreme Court case, Alabama Asphaltic and certain cases which followed it, as standing for the proposition that the creditors of a bankrupt company are effectively the equity owners. In that case the transfer of stock ownership to the creditors was considered a nontaxable reorganization because there was continuity of ownership by virtue of the creditors' implicit ownership of the corporation. Because asset basis generally carries over in nontaxable reorganizations, this would mean no step up in basis for the assets of Ralphs Grocery Co.

Tax Court Decision

In the end, the Tax Court sided with the new owners of Ralphs and held that a taxable sale had taken place and there was a valid Sec. 338(h)(10) election and a step up in basis of assets. Under the existing definition of continuity of interest, there was no identity of ownership after the transfer, the court ruled. The Judge distinguished the Ralphs case from Alabama Asphaltic on the facts. In the older case the creditors had formed a committee early on and did indeed begin to exercise significant control over the company characterized by the Court as "effective command." Among other differences, in the older case the creditors commenced an involuntary petition in bankruptcy whereas Federated filed a voluntary petition; in Ralphs, the stock went not to a Ralphs' creditor but to creditors of other members of the group.

Potential Effect on Future Type G Reorganizations

In future bankruptcy cases where the parties agree they want a Type G taxfree reorganization with the creditors receiving the business in a new corporate entity, will they have to be careful to avoid the facts of Ralphs to avoid taxable sale treatment? It is a fairly common fact pattern for a debtor in bankruptcy to transfer its business or one of its businesses to a new corporation and distribute that to the creditors. Will the parties have to take steps to mimic the Alabama Asphaltic facts, such as early formation of a creditors committee and taking "effective command" of the debtor, to establish continuity of interest to achieve a valid Type G reorganization?

Commentary

This case illustrates an important point, whatever position a taxpayer takes, the IRS can usually raise tax by "going opposite." In the more common case, if you think you have a nontaxable transaction, the IRS is incented to treat it as taxable. The Ralphs' case shows that even if you think you are being conservative and reporting it as a taxable sale, the IRS can try to characterize it as nontaxable if that is to their advantage. This risk of alternate interpretations is present in almost all transaction tax planning.

By the way, the "deemed sale" technique used in Ralphs is an important tool in the restructuring advisor's tool kit both in and outside the bankruptcy setting. While in the Ralphs case the stock of the old Ralphs Grocery Co. was merged into a new corporate entity for some reason before being transferred, in the typical 338(h)(10), you just sell the stock of the target company and it is treated as if you sold the underlying assets. In fact, that is the pointyou don't want to change the entity in which the assets reside. The 338(h)(10) technique is useful in any case where the target corporation has contracts, licenses, financing arrangements, intangible assets, favorable leases, tax abatements, etc., which you do not want to disturb by transferring them individually just to get sale treatment and basis step-up. Sometimes you just want to avoid the trouble of retitling assets, incurring transfer taxes, and so forth. With regulated entities, this technique is often used to avoid the need to get regulatory permission to change the legal entity owning the assets. The technique is also available where the seller is an S corporation and the buyer is a C corporation. This technique will be covered in more depth in a future article. ■

Thanks to Attorney Jack Cummings for his insights. Thanks to Grant Newton and Dennis Bean for their assistance with this article.

IRS MILITANT ON INTEREST RATE, SECURITY IN PLAN OF REORGANIZATION

A recent case illustrates how far the Internal Revenue Service will go to protect the government's interest in a bankruptcy claim. In the case of *In re Walter Williams, Inc. US v. Walter Williams, Inc., Appellee*(U.S. District Court, C.D. California; CV 10-

4064-JST, March 15, 2011, 2011-1 ustc ¶50,294), the IRS attacked a confirmed bankruptcy plan of reorganization in District Court over the interest rate allowed on the IRS claims and certain security and repayment terms.

Background

On July 23, 2007, Debtor corporation filed a voluntary bankruptcy petition pursuant to Chapter 11; however its owners, Michael and Janeen Van Eaton, did not file a petition. On August 23, 2007, the IRS filed a proof of claim against the debtor corporation for federal employment taxes in the amount of $402,866.98, which was comprised of a secured claim of $247,121.58, a priority claim of $149,799.24, and an unsecured general claim of $5,946.16. After much haggling and many amended claims, the secured claim was reduced to about $185,000.

On April 25, 2008, Debtor filed its initial Plan of Reorganization. The Government, on behalf of the IRS, objected to the initial Plan for various reasons, including that the Plan improperly attempted to designate that Debtor's payments under the Plan first apply to the trust fund portion of the IRS claim, failed to provide interest with respect to the IRS administrative claim, and failed to provide the proper rate of interest for the IRS secured claim. After many revisions to the Plan, the bankruptcy court confirmed it on May 11, 2010. The Government was still not satisfied with its position and filed its notice of appeal on May 28, 2010, with the District Court. These are the issues raised and how they were decided:

Formula for Payment of Trust Fund Taxes

Trust fund taxes are payroll withholding taxes that an employer has withheld from employee wages but failed to pay over to the IRS, which have a very high status in federal tax law. IRC 6672 imposes a penalty on the responsible person who failed to pay over the taxes even if the business was operated in corporate form. Apparently the secured tax liability of the debtor corporation of $185,000 were related to the unremitted trust fund taxes and the Van Eatons had been assessed the personal penalty for the unpaid withholding taxes. The Plan provided that any voluntary payments the Van Eatons made toward the unpaid trust fund taxes should not be automatically credited against the secured claim until it was clear that all IRS tax claims against the debtor corporation would be paid. The District Court held against the IRS on this issue remanding it to the Bankruptcy Court with instructions that the Plan should simply state that any payment made by the Van Eatons would be applied in the same manner as a payment by the debtor corporation.

Interest Rate on the Government's Allowed Tax Claims

The Plan provided for an interest rate on the IRS secured tax claim of 3.5% which apparently was the rate charged by IRS on underpayments of tax per IRC 6621 at the time and which the IRS had objected to all along, arguing for a rate of about 6%. Under Bankruptcy Code section 511(a), "[i]f any provision of this title requires the payment of interest on a tax claim or on an administrative expense tax, or the payment of interest to enable a creditor to receive the present value of the allowed amount of a tax claim, the rate of interest shall be the rate determined under applicable nonbankruptcy law" (this provision was enacted as part of BAPCPA 2005). The District Court stated:

In a Chapter 11 bankruptcy, the Ninth Circuit has held that the rate of interest the debtor must pay the Government on deferred payments of federal taxes is equal to "the rate the debtor would pay a commercial lender for a loan of equivalent amount and duration, considering the risk of default and any security." *In re Camino*, 818 F.2d at 1504. This is because BC section 1129(a)(9)(C) requires that the "aggregate receipts over the payment period [must] equal the present value of its tax claims."

Again, the District Court remanded the case to the bankruptcy court with instructions to employ the approach in *In re Camino* in determining the applicable interest rate.

Potential Discharge of "Gap Interest"

The Government was concerned about a possible discharge of some of the accrued interest based on the following language from the confirmation order:

Except as otherwise provided in the Plan, as modified, this Order acts as a discharge and termination as of the Effective Date, of any and all liabilities and debts of, and claims against the Debtor that arose at any time before the confirmation order becomes a final order, including but not limited to, the principal amount of any claims and any and all interest accrued thereon, pursuant to 11 U.S.C. section 1141(d)(1).

The Government contended that as a result of this language, the IRS "gap interest" that accrued between the date of the petition (July 23, 2007) and the confirmation order (May 11, 2010) was improperly discharged. "Gap interest" is post-petition, pre-confirmation interest. *Miller v. United States*, 363 F.3d 999, 1001 (9th Cir. 2004). In *Miller*, the Ninth Circuit held

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that "gap interest" on nondischargeable tax claims is not subject to bankruptcy discharge. The District Court ruled "Here, it is ambiguous as to whether the Plan and confirmation order, read together, attempt to discharge the IRS gap interest... the Court instructs the bankruptcy court in its revised confirmation order to state that the Debtor's discharge does not apply to the IRS gap interest."

Lack of Security Due to "Segregated Inventory"

The IRS had a valid lien on all the debtor's real and personal property which included some valuable artworks. [Apparently the debtor had money to buy artworks, just not to pay employee withholding taxes.—FL]. For some reason the Plan provided that some of the debtor's "inventory" would be set aside and sold at auction to satisfy the secured IRS claim. In the District Court action the IRS argued that this segregation might result in less sale proceeds than the amount of the secured claim. The District Court ordered that the Plan be revised to include no segregation which might impair the IRS lien.

Commentary

While the Internal Revenue Code provides for the payment of interest on all taxes not timely paid, the Bankruptcy Code does not have a blanket rule. According to BC 506(b), "To the extent that an allowed secured claim is secured by property the value of which…is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim." Also, as mentioned in the opinion, a chapter 11 plan of reorganization cannot be confirmed unless the plan provides that tax claims are to receive payment in full or regular cash payments, over a period not exceeding five years from the date of the order of relief, with a value as of the effective date of the plan equal to the allowed amount of such claim (or the claimant agrees to a different treatment). Thus, post-confirmation interest on a priority tax claim must be paid in order to meet the requirements for plan confirmation. Generally the effect of BAPCPA 2005 has been to require interest to be paid on more claims, especially on state and local taxes where the "commercial loan rate" is not necessarily used but reference is made to the rate charged under the various state and local tax statutes. A rate of 12% was used in one Texas case (Grant Newton warned about this issue at the time the act was passed). ■

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

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Bankruptcy Cases

Baxter Dunaway

FORECLOSURE OF SECURITIZED MORTGAGES

Supreme Court Massachusetts

Can a foreclosing bank get title to property without proper assignment of mortgage to bank prior to foreclosure?

The Massachusetts *Ibanez* case[1] has been closely watched, particularly in connection with securitized loan transactions.[2] After foreclosing on two properties and purchasing the properties back at the foreclosure sales, U.S. Bank, as trustee for the Structured Asset Securities Corporation Mortgage Pass-Through Certificates, Series 2006-Z; and Wells Fargo, as trustee for ABFC 2005-OPT 1 Trust, ABFC Asset Backed Certificates, Series 2005-OPT 1 (plaintiffs), filed separate complaints in the Land Court asking a judge to declare that they held clear title to the properties in fee simple. The Massachusetts Supreme Court agreed with the trial judge that the plaintiffs, who were not the original mortgagees, failed to make the required showing that they were the holders of the mortgages at the time of foreclosure.[3] As a result, they did not demonstrate that the foreclosure sales were valid to convey title to the subject properties, and their requests for a declaration of clear title were properly denied. *U.S. Bank Nat. Ass'n v. Ibanez,* 458 Mass. 637, 638; 941 N.E.2d 40 (Mass. Jan 07, 2011) (NO. SJC-10694). The two complaints sought identical relief: (1) a judgment that the right, title, and interest of the mortgagor (Ibanez or the LaRaces) in the property was extinguished by the foreclosure; (2) a declaration that there was no cloud on title arising from publication of the notice of sale in the Boston Globe; and (3) a declaration that title was vested in the plaintiff trustee in fee simple. U.S. Bank and Wells Fargo each asserted in its complaint that it had become the holder of the respective mortgage through an assignment made *after* the foreclosure sale. The Appeals Court granted the plaintiffs' motion to consolidate these cases. The judge ruled that the foreclosure sales were invalid because, in violation of Massachusetts G.L. c. 244, § 14, the notices of the foreclosure sales named U.S. Bank (in the Ibanez foreclosure) and Wells Fargo (in the LaRace foreclosure) as the mortgage holders where they had not yet been assigned the mortgages. The judge found, based on each plaintiff's assertions in its complaint, that the plaintiffs acquired the mortgages by assignment only after the foreclosure sales and thus had no interest in the mortgages being foreclosed at the time of the publication of the notices of sale or at the time of the foreclosure sales.

In the third case, LaSalle Bank National Association, trustee for the certificate holders of Bear Stearns Asset Backed Securities I, LLC Asset-Backed Certificates, Series 2007-HE2, the judge

1 U.S. Bank Nat. Ass'n v. Ibanez, 458 Mass. 637, 638; 941 N.E.2d 40 (Mass. Jan 07, 2011).

2 See generally Prof. Dan Schecter, Mortgage Foreclosures by Securitization Trusts Are Invalid Because Indenture Trustees Failed to Prove Valid Chain of Assignments From Loan Originators (U.S. Bank, N.A., v. Ibanez (Mass.), 2011 comm. fin. news. 8 (January 24, 2011) (discussing Ibanez case and noting that proper documentation issues still exist even though banks have had ample notice, time, and opportunity to correct the problems, and stating that "despite these early wake-up calls, the problem still exists in 2011"); Banks Can't Get Title to Property Without Proper Assignment of Mortgage Before Foreclosure Sale, 39 NO. CD-2 HDR current developments 36 (January 17, 2011) (discussing holding in Ibanez case and noting that "The decision highlighted the dispute over the validity of mortgage transfers, which has emerged as a major issue in the continuing foreclosure crisis"); Jeffrey B. Steiner and Zachary Samton, Dating Tips For Real Estate Attorneys, 245 n.y.l.j. 5 (col. 2) (January 19, 2011) (stressing importance of proper dating of real-estate documents and noting the pitfalls of improper dating of such documentation as illustrated in the Ibanez decision).

3 "We have long held that a conveyance of real property, such as a mortgage, that does not name the assignee conveys nothing and is void; we do not regard an assignment of land in blank as giving legal title in land to the bearer of the assignment." 458 Mass. 637, 652.

concluded that the mortgage foreclosure "was not rendered invalid by its failure to record the assignment reflecting its status as holder of the mortgage prior to the foreclosure since it was, in fact, the holder by assignment at the time of the foreclosure, it truthfully claimed that status in the notice, and it could have produced proof of that status (the unrecorded assignment) if asked."[4]

The *Ibanez* case undoubtedly was properly decided on the failure to prove possession or proper transfer of the mortgages. But the issue of whether the mortgage follows the note automatically under Article 9 of the UCC (which trumps prior state law) was not addressed by or dealt with by the court. The Massachusetts Supreme Court in *Ibanez* acknowledged that "in some jurisdictions it is held that the mere transfer of the debt, without any assignment or even mention of the mortgage, carries the mortgage with it, so as to enable the assignee to assert his title in an action at law."[5] An analysis of this issue therefore must be done on a case-by-case basis, depending on the law of the jurisdiction where the property is located—and Uniform Commercial Code ("UCC") law and regulations.

As clearly illustrated in the *Ibanez* case, an issue may arise regarding the valid assignment of a mortgage from the original lender of a mortgage that is later securitized and assigned to a servicer or to a named third party as trustee of a securitized trust. If it cannot be proven that the note evidencing the debt (of which the mortgage is security) was properly assigned, this could create problems. With respect to the assignment of a single mortgage, or a bundle of securitized mortgages from an original lender to, e.g., a bank as trustee of a securitized trust, the mortgage will automatically follow the note[6] and be automatically perfected under sec. 9-109(a)(3) and 9-309(4) of the UCC, regardless of state law to the contrary.[7]

BANKRUPTCY

Second Circuit

In a Chapter 11 reorganization, are "Gift" Plans permitted under the Absolute Priority Rule?

The Second Circuit Court of Appeals held that in Chapter 11 reorganizations, senior creditors may not "gift" recoveries to junior creditors and/or equity interest holders over the objection of an intervening class because this would not be permitted by the Absolute Priority Rule,[8] which is codified as 11 U.S.C. § 1129(b)(2)(B).[9] *In re DBSD North America, Inc*., --- F.3d ----, 2011 WL 350480 (2nd Cir. (N.Y.) Feb 07, 2011) (NO. 10-1175, 10-1201, 10-1352).

These closely- watched consolidated appeals in the Second Circuit arise out of the bankruptcy of DBSD North America, Inc., and its various subsidiaries (together, "DBSD"). The bankruptcy court confirmed a Chapter 11 plan of reorganization for DBSD over the objections of the two appellants, Sprint Nextel Corporation ("Sprint") and DISH Network Corporation ("DISH").

Sprint's claim was an unliquidated, unsecured claim based on a suit against a DBSD subsidiary. Sprint had sued seeking reimbursement for DBSD's share of certain spectrum relocation expenses under an FCC order. Sprint raised only one issue on appeal. It asserted that the plan improperly gives property to DBSD's shareholder without fully satisfying Sprint's unsecured senior claim, in violation of the absolute priority rule.[10] That rule provides that a reorganization plan may not give "property" to the holders of any junior claims or interests "on account of" those claims or interests, unless all classes of senior claims either receive the full value of their claims or give their consent.[11] Because the existing shareholder received shares and warrants on account of its junior interest, Sprint argued, Sprint's class of general unsecured creditors had a right to receive "full satisfaction of their claims" or at least "an amount sufficient to obtain approval from the class." But the plan provided neither, and so Sprint asked the Court of Appeals to vacate the order confirming it or to provide other relief that would satisfy Sprint's claim.

Sprint argued that the plan violated the absolute priority rule by giving shares and warrants to a junior class (the existing shareholder) although a more senior class (Sprint's class) neither approved the plan nor received the full value of its claims.[12] The appellees responded, and the courts below held, that the holders of the Second Lien Debt, who are senior to Sprint and whom the bankruptcy court found to be undersecured, were entitled to the full residual value of the debtor and were therefore free to "gift" some of that value to the existing shareholder if they chose to.

The Court of Appeals reviewed the precedents supporting the "gifting" exception to the Absolute Priority Rule and distinguished those cases and strictly applied the Absolute Priority Rule as codified in 11 U.S.C. § 1129(b)(2)(B). The Court held that the Chapter 11 plan violated the absolute priority rule by giving shares and warrants to a junior class, namely, debtors' existing shareholder, "in exchange for" or "because of" its prior, junior interest, even though a more senior class, namely, unsecured creditor's class, neither approved the plan nor received the full value of its claims. Notwithstanding the various economic reasons that may have contributed to the decision to award property to old equity, including the desire to ensure existing shareholder's continued cooperation and assistance in the reorganization, it was clear that existing shareholder could not have gained its new

4 458 Mass. 637, 655, FN 8.

5 458 Mass. 637, 652-3. See Kirk D. Jensen, Esq., and Andrew R. Louis, Ibanez: a 19th-century Decision for the 21st Century, 16 No. 20 WJBLL, 1, February 14, 2011.

6 Kirk D. Jensen, Esq., and Andrew R. Louis, Ibanez: a 19th-century Decision for the 21st Century, 16 No. 20 WJBLL, 1, February 14, 2011.

7 See Nelson and Whitman, Outright transfers of notes revisited under new Article 9, Real Estate Finance Law § 5.28, p. 558-9 (5th ed. 1997, Westlaw 1 REALFNLAW § 5.28 and Dunaway, The Law of Distressed Real Estate Law § 18:17 Automatic perfection (Westlaw LAWDRE).

8 See Dunaway, The Law of Distressed Real Estate (Westlaw database LAWDRE), § 29:62. Requirements for confirmation, FN 4.

9 Certain courts have permitted deviation from the absolute priority rule in certain circumstances, pursuant to "gift plans." See In re SPM Manufacturing Corp., 984 F.2d 1305, 1313 (1st Cir. 1993). The First Circuit held, in often quoted language, that "creditors are generally free to do whatever they wish with the bankruptcy dividends they receive, including to share them with other creditors." In re SPM Manufacturing Corp., 984 F.2d 1305, 1313 (1st Cir. 1993) . See Pre-plan Settlements and "Gift Plans" 15 Years After In re SPM Manufacturing Corp. Still No Bright Lines, Only Sympathetic Winners, 28-FEB Am. Bankr. Inst. J. 54 (2009).

10 See 11 U.S.C. § 1129(b)(2)(B). See Dunaway, The Law of Distressed Real Estate (Westlaw database LAWDRE), § 29:62. Requirements for confirmation, FN 4.

11 See In re Coltex Loop Cent. Three Partners, L.P., 138 F.3d 39, 42 (2d Cir.1998); see also In re Armstrong World Indus., Inc., 432 F.3d 507, 512 (3d Cir.2005).

12 See 11 U.S.C. § 1129(b)(2)(B).

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position but for its prior equity position, and, under the plain text of the Bankruptcy Code, secured creditors were not entitled to "gift" the shares and warrants to existing shareholder as they saw fit.

It is not yet clear whether this case will be followed in other important jurisdictions, such as the Third Circuit, which includes Delaware. Prof. Stephen J. Lubben (Seaton Hall Law) has commented on the *DBSD* case to the effect that the "gift" plan appears to be dead in the Second and Third Circuits but there is a way to accomplish the same result outside a bankruptcy plan:[13]

> The facile conclusion is to say none of this matters, since the secured lender can simply agree to make a side payment after the Chapter 11 cases is over to the junior claimant. *** But what if the senior lender was simply open about the arrangement? For example, the senior lender might say it intended to give certain managers a stake in the reorganized business after the senior lenders obtained control of the business through bankruptcy in order to maximize the value of the asset. In such a case, I doubt there could be any objection. Indeed, this is essentially what happened in the Chrysler bankruptcy case with regard to the American and Canadian governments giving a stake to Fiat after the completion of the sale under Section 363 of the bankruptcy code, so that Fiat would run the company for them.

First Circuit Bankruptcy Appellate Panel

Does a debtor without equity in the property have standing to appeal from an order granting in rem stay relief after the case is converted from a Chapter 11 to a Chapter 7?

First Circuit BAP holds that a debtor has no standing to appeal from an order granting in rem stay relief after the case is converted from a Chapter 11 to a Chapter 7. *In re Aja*, 2011 WL 167034 (B.A.P. 1st Cir. 2011). In this case the court explained that only a "person aggrieved" has standing to pursue an appeal and that a "person aggrieved" is one whose property is diminished, burdens are increased, or rights are impaired by order on appeal. Generally, an insolvent chapter 7 debtor does not have standing to appeal. This is so because under the Code their legal and equitable property interests pass to the bankruptcy estate and all prepetition creditors' claims become estate liabilities. *See* § 541(a) (commencement of case "creates an estate"); § 502 (allowance of claims); Debtor normally has no interest in the distribution of estate's property.

Fifth Circuit

Does a third-party lender that pays debtor's tax debt and receives a transfer of the local taxing authority's tax lien hold a "tax claim" and is entitled to interest pursuant to § 511?

A third-party lender that pays debtor's tax debt and receives a transfer of the local taxing authority's tax lien holds a "tax claim" and is entitled to interest pursuant to § 511. *Tax Ease Funding, L.P. v. Thompson (In re Kizzee-Jordan)*, No. 09-20777, 2010 WL 4518644 (5th Cir. Nov. 11, 2010).

The Debtors Thompsons filed in the Bankruptcy Court a petition for Chapter 13 reorganization. Their reorganization plan proposed to repay the debt to Tax Ease at an annual interest rate of only 5%. Tax Ease objected to the plan on the ground that under 11 U.S.C. § 511 its claim for repayment was a tax claim for which the interest rate must be determined by nonbankruptcy law and may not be modified by the bankruptcy court. Tax Ease sought by its objection to preserve its contract rate of interest. The sole issue in this appeal turns on the applicability of § 511 of the Bankruptcy Code. Enacted as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, *See* Pub.L. No. 109-8, § 704, 119 Stat. 23, 125-26 (2005), § 511 limits a debtor's ability to modify the interest rate on a "tax claim" as follows:

> If any provision of this title requires the payment of interest on a tax claim or on an administrative expense tax, or the payment of interest to enable a creditor to receive the present value of the allowed amount of a tax claim, the rate of interest shall be the rate determined under applicable nonbankruptcy law.[14]

Because there was no uniform rate of interest for tax claims prior to the enactment of § 511, and varying standards had been used to determine the applicable rate, Congress sought to simplify the interest rate calculation.[15] It is now clear that when a federal, state, or local governmental entity pursues a claim against a bankrupt for unpaid taxes, the applicable interest rate is determined in accord with nonbankruptcy law. What is not immediately clear from the statute is whether a third-party creditor who pays the debtor's taxes continues to hold a "tax claim." The Bankruptcy Code does not define the term "tax claim." The district court held that Tax Ease's claim was a tax claim under § 511. The district court reasoned that the debt originated from the debtors' responsibility to the taxing authorities for their property taxes and that the transfer of the debt to Tax Ease did not change the nature of the debt. It noted that under Texas law Tax Ease became subrogated to the rights of the taxing authorities. Therefore, Tax Ease was entitled to the same protection of § 511 that would be afforded to the taxing authorities, and the bankruptcy court could not modify the interest rate. The Court of Appeals affirmed the holding of the district court.

Tenth Circuit

Did the bankruptcy court exceed its authority by entry of a contempt order without an actual hearing and voiding the actions taken by creditors in violation of the automatic stay ?

The bankruptcy court did not exceed its authority by voiding the actions taken by creditors in violation of the automatic stay. *In re C.W. Mining Co.*, 625 F.3d 1240, Bankr. L. Rep. P 81,884 (10th Cir. Nov 08, 2010) (NO. 10-4028).

Creditors that were held in civil contempt by the bankruptcy court for violating the automatic stay pursuant to 11 U.S.C.A. § 362(a) that arose in debtor's involuntary bankruptcy case were not denied due process in connection with entry of contempt order. Creditors were given reasonable notice and a meaningful opportunity to be heard, as their attorney

13 Prof. Stephen J. Lubben, Ruling Appears to End Chapter 11 'Gift' Plans, DealBook, 2011 WLNR 2503073 (February 8, 2011).

14 11 U.S.C. § 511(a).

15 FN12. See H.R.REP. NO. 109-31, at 101 (2005), U.S. Code Cong. & Admin.News 2005, p. 88; see also 4 COLLIER ON BANKRUPTCY ¶ 511.01 (Alan Resnick & Henry J. Sommer, eds. 16th ed. 2010) ("The purpose of section 511 is to establish uniformity in the rate of interest paid on deferred tax claims[.]").

was served with contempt motion and notice of hearing, notice expressly stated dates set for objection deadline and hearing on motion, bankruptcy court confirmed these dates in its scheduling order. Creditors had meaningful opportunity to respond until deadline but, instead of filing objection to contempt motion, they filed motions to dismiss and enlarge time, and when creditors failed to respond to contempt motion by deadline, petitioning creditor filed certificate of non-response and the court granted relief pursuant to local rule. U.S.C.A. Const. Amend. 5.

First Circuit Bankruptcy Appellate Panel

Did a mortgage servicer violate the automatic stay through the following three acts: filing a proof of claim, sending the annual tax statement, and sending the payoff statements?

The First Circuit BAP held that a mortgage servicer did not violate the automatic stay through the following three acts: filing a proof of claim, sending the annual tax statement, and sending the payoff statements. *In re Knowles*, --- B.R. ----, 2011 WL 9409 (1st Cir.BAP (Me.) Jan 03, 2011) (NO. ADV 08-01020-LHK, BR 05-13492-LHK, EB 10-022).

In rejecting the allegation that the creditor had violated the automatic stay the BAP noted that the automatic stay is "extremely broad in scope" in that it prohibits almost all formal and informal acts taken against the debtor or the estate. Lawrence P. King et al., *Collier on Bankruptcy* ¶ 362.03 (15th ed. rev. 2007). The stay, however, does not prohibit all communication or actions by a creditor to a debtor. *Morgan Guar. Trust Co. of N.Y. v. Am. Sav. & Loan Ass'n (In re Morgan Guar. Trust Co. of N.Y.),* 804 F.2d 1487, 1491 (9th Cir.1986). For instance, a "mere request for payment" does not violate the stay unless it is coercive or harassing. *Id.* Likewise, an act does not violate the stay unless it immediately or potentially threatens the debtor's possession of its property, such that the debtor is required to take affirmative acts to protect its interest. *Id.* The filing of the proof of claim is not an act against property of the debtor or the estate. *See* 11 U.S.C. § 362; *Campbell v. Countrywide Home Loans, Inc. (In re Campbell),* 545 F.3d 348, 355-56 (5th Cir.2008) (holding that automatic stay did not bar creditor from filing proof of claim); *Zotow v. Johnson (In re Zotow),* 432 B.R. 252, 261 (9th Cir. BAP 2010) (explaining that automatic stay "serves to control creditor action by encouraging creditors to participate in the bankruptcy process to resolve their claims"). The filing of a proof of claim merely indicates a desire to participate in the bankruptcy process. *See In re Campbell,* 545 F.3d at 355-56. It is not a request for payment from the debtor or an attempt to act against property of the debtor. It is certainly an act against property of the estateone files a proof of claim in order to recover from the estatebut one the Code expressly sanctions: "[a] creditor ... may file a proof of claim." 11 U.S.C. § 501(a). Similarly, the sending of the annual tax statement was not an act against property of the Debtor or the estate. *See* 11 U.S.C. § 362; *In re Morgan,* 804 F.2d at 1491; *In re Zotow,* 432 B.R. at 261. The statement was merely an informative document sent in the normal course of business that contained data the Debtor needed in order to prepare her tax return. Because nothing in the statement can be construed as an attempt by Bayview to seek payment from the Debtor, Bayview's sending it was not violative of the stay. *See* 11 U.S.C. § 362; *In re Morgan,* 804 F.2d at 1491; *In re Zotow,* 432 B.R. at 261. Nor was Bayview's transmission of the payoff statements an act against property of the Debtor or the estate. *See* 11 U.S.C. § 362; *In re Morgan,* 804 F.2d at 1491; *In re Zotow,* 432 B.R. at 261. The Debtor in fact requested the payoff information, and Bayview noted in both statements that it was providing the information pursuant to that request. Additionally, both statements contained language making it clear that the Debtor was not immediately obligated to pay anything beyond her normal mortgage payment and that the "total amount due" was only if the Debtor opted to pay off the loan in full.

Sixth Circuit Bankruptcy Appellate Panel

Can debtor who has no equity in real property use rents to pay professional fees?

Sixth Circuit Bankruptcy Appellate Panel holds that debtor who has no equity in real property cannot use rents to pay professional fees. *In re Buttermilk Towne Center, LLC*, --- B.R. ----, 2010 WL 5185870 (6th Cir.BAP (Ky.) Dec 23, 2010) (NO. 10-8036, 10-8046, 10-8062).

Under Kentucky law, Chapter 11 debtor's prepetition assignment of rents to mortgagee did not give absolute ownership of rents to mortgagee, but served only as additional security for debt used to finance commercial real estate development. According to the agreement debtor retained the right to collect rents so long as it was not in default of mortgage, and even if default occurred, giving mortgagee the right to collect rents. The rents could only be used to reduce debtor's debt to mortgagee, and the assignment automatically terminated when debt to mortgagee was satisfied. Additionally, as observed in *In re Guardian Realty Group, LLC,* 205 B.R. 1 (Bankr.D.D.C.1997) the majority of cases to consider language in a security agreement granting a mortgagee an alleged absolute assignment of rents have found the true nature of the mortgagee's interest to be no more than security even in those states following the "title theory" of mortgages. *See e.g., In re McCann,* 140 B.R. 926, 927 (Bankr.D.Mass.1992); *In re Bethesda Air Rights Limited Partnership,* 117 B.R. 202, 206 (Bankr.D.Md.1990) ("title theory" state); *In re Willowood East Apartments of Indianapolis II, Ltd.,* 114 B.R. 138, 141 (Bankr.S.D.Ohio 1990).

Further the panel held that a replacement lien in commercial real estate rents in which mortgagee had independent security interest did not provide adequate protection to mortgagee for Chapter 11 debtor's use of rents as cash collateral to pay professional fees.

Eleventh Circuit

Is "Good faith" a requirement of mere conduit or control test applied in determining liability for avoided fraudulent transfer as "initial transferee" under Bankruptcy Code 11 U.S.C.A. § 550(a)(1)?

The Eleventh Circuit holds that Good Faith is a requirement of mere conduit or control test applied in determining liability for avoided fraudulent transfer as "initial transferee" under Bankruptcy Code. 11 U.S.C.A. § 550(a)(1). *In re Harwell*, 628 F.3d 1312, 1323, Bankr. L. Rep. P 81,909, (11th Cir.(Fla.) Dec 29, 2010) (NO. 09-14997).■

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Interest Privilege continues from p. 1

The insurers asserted that the common interest asserted by the Plan Parties – that of preserving and maximizing the estate's insurance assets – was, at best, a shared *commercial*, not *legal*, interest.[10] Further, the insurers claimed that the Plan Parties lacked a common issue when the documents were exchanged because at that time they had yet to agree on the terms of a plan and were adversaries with respect to the debtor's insurance proceeds.[11]

The court rejected the insurers' argument, finding the precedent they cited factually distinguishable or favorable to Leslie. The cases established that the party claiming the common interest privilege must present evidence implicating a *legal* interest.[12] Leslie met that standard because, when it exchanged the documents, the Plan Parties all shared the interest of preserving and maximizing the debtor's insurance assets to pay asbestos claims:

> As representatives of the ultimate beneficiaries of at least a portion of the proceeds [the Ad Hoc Committee and the Pre-Petition FCR] were directly involved in the effort to maximize insurance coverage. They were working with the Debtor to maximize the size of the pie. Whether their competing interests in getting the biggest piece of the pie prevented the application of the common interest doctrine in this case is another matter.[13]

The interest of maximizing the insurance assets was "inherently legal" because it involved analysis of insurance documents and contract, insurance and bankruptcy law and proceedings in the bankruptcy court.[14]

The court declined to adopt a black-line rule "that parties engaged in negotiations cannot share a common interest[,]" because the particular facts of each case determine whether a common interest exists.[15] The facts of *Leslie* showed that, although the Plan Parties had conflicting interests as to distribution of the debtor's assets, they shared a common interest in maximizing those assets against the insurers, their "common enemy":

> To return to the pie analogy, the size of the pie and the size of the pieces are two separate questions. The parties are in accord as to the former and adversaries as to the latter. The information contained in the documents that were shared with the Ad Hoc Committee and the Pre-Petition FCR goes to the size of the asset pool – a matter of common interest.[16]

Because the Plan Parties shared a common legal interest, all 26 documents were protected from discovery under the common interest doctrine.[17]

Pursuant to the *Leslie* opinion, parties negotiating a chapter 11 plan of reorganization may rely on the common interest privilege to exchange documents in furtherance of the common legal interest of preserving and maximizing the debtor's assets. The protection is not negated simply because the exchange occurs before the parties agree to plan terms and have competing interests as to whose constituency will receive the biggest piece of the debtor's asset pie.

Tribune—Shared Interest in Obtaining Court Approval of Proposed Settlement and Plan

In *Tribune*, Judge Carey adopted and followed much of the reasoning of *Leslie* to resolve a discovery dispute between competing proponents of reorganization plans. The Tribune Company and certain of its subsidiaries (the "Debtors") filed for bankruptcy protection on December 8, 2008.[18] In 2007, Tribune had been the subject of a leveraged buyout, which gave rise to certain potential causes of action (the "LBO Causes of Action").[19] On September 1, 2010, the court appointed Bankruptcy Judge Kevin Gross to mediate negotiations among various parties with respect to a plan of reorganization and a resolution of the LBO Causes of Action.[20] After the mediation, four competing plans were filed, including one proposed by certain noteholders (the "Noteholders" or "Noteholder Plan Proponents") and one proposed by the Debtors, the Official Committee of Unsecured Creditors (the "Committee") and certain lenders (the "Lenders", collectively with the Debtors and the Committee, the "Debtor/Committee/Lender Plan Proponents" or "DCL Plan Proponents").[21]

The Noteholders filed a motion to compel documents from the Debtor/Committee/Lender Plan Proponents regarding their plan's proposed settlement of the LBO Causes of Action to "test the arms-length nature and good faith of the settlement negotiations."[22] The dispute focused on objections to producing documents (1) protected by the common interest privilege, (2) protected by a mediation order (the "Mediation Order", which directed that all mediation discussions, documents and communications were confidential, inadmissible, and could not be disclosed to any non-party[23]), Local Bankruptcy Rule 9019-5(d) and Federal Rule of Evidence 408, and (3) for the time period from the petition date to December 15, 2009, when the court entered an order authorizing the Debtors to create a centralized document depository program in connection with the Committee's investigation of the LBO Causes of Action (the "Document Depository Order").[24] With respect to the common interest privilege, the parties disputed whether the privilege applied and, if so, when the privilege arose and the scope of its protection.

The Noteholders argued that the common interest privilege did not apply because the Debtors, the Committee, and the Lenders shared no common interest; the former two wanted to maximize the estate, while the latter wanted to resolve the LBO Causes of Action by paying the least amount possible.[25] The DCL Plan Proponents asserted that they shared a common legal interest to gain court approval of their proposed plan and settlement.[26]

The *Tribune* Court adopted the reasoning of *Leslie* as to the elements and applicability of the common interest privilege and its recognition that the existence of a common interest "must be determined on a case by case basis."[27] Although their interests were not completely in accord, the court concluded that the DCL Plan Proponents shared a community of

10 Id.
11 Id. at 498
12 Id. at 500.
13 Id.
14 Id.
15 Id. at 501-02.
16 Id. at 502.
17 Id. at 503.
18 Tribune, 2011 Bankr. LEXIS 299, *3-4.
19 Id. at *4 n.6.
20 Id. at *7-8.
21 Id. at *2-3, 9.
22 Id. at *11.
23 Id. at *26-27 n.18.
24 Id.
25 Id. at *12-13.
26 Id. at *13.
27 Id. at *13-16.

interests based on their common legal interest to resolve the legal dispute among them by obtaining court approval of their proposed settlement and plan.[28]

As to when the common interest privilege arose, the DCL Plan Proponents asserted they had a common interest when the mediator filed the parties' term sheet on October 12, 2010.[29] The Debtors and two lenders claimed they shared an interest as of September 27, 2010, when they agreed to become plan proponents and resolve the LBO Causes of Action.[30] The Noteholders argued no privilege existed until the DCL Plan Proponents filed their plan on November 23, 2010, and the term sheets were not a sufficient trigger because the parties had continued to negotiate the plan terms.[31] The court agreed with the DCL Plan Proponents that their common interest arose on October 12 (and on September 27 for the Debtors and two lenders) because they had agreed upon the material terms of their settlement and "it is reasonable to conclude that the parties might share privileged information in furtherance of their common interest of obtaining approval of the settlement through confirmation of the plan."[32] Whether particular communications were protected based upon that common interest depended on the DCL Plan Proponents' ability to demonstrate that the communications were privileged and met the three-part test of *Leslie*.[33]

With respect to the scope of the privilege, the Noteholders argued the common interest covered only communications written or made by lawyers because the privilege only applied to communications protected by the attorney-client privilege or work product doctrine.[34] The DCL Plan Proponents objected that the Noteholders' attempt to limit the "common interest communications" to those prepared by lawyers would artificially limit the privilege and needlessly require the funneling of communications through attorneys.[35] The court concluded that the Noteholders' proposal was too restrictive, noting that the DCL Plan Proponents would have the opportunity to show that the discovery sought was covered by the privilege.[36]

28 Id. at *15-16.
29 Id. at *16-17.
30 Id. at *17.
31 Id.
32 Id. at *17-18.
33 Id. at *18 n.13.
34 Id. at *19.
35 Id. at *23.
36 Id. at *23-24.

The Noteholders argued that the mediation information sought was not protected by the Mediation Order, Local Rule 9019-5(d) or Fed. R. Evid. 408 because the DCL Plan Proponents put the requested discovery at issue by claiming their settlement was fair as a result of mediation with a judge and that it was unfair for the DCL Plan Proponents to use the Mediation Order as both a sword and a shield.[37] In response, the DCL Plan Proponents offered to disclose information regarding the mediation process, but not its substance, by producing communications (1) about the negotiation and abandonment of an earlier proposed plan, (2) prior to mediation, and (3) that occurred outside the mediator's presence or on a non-mediation day.[38]

The court noted that courts within the Third Circuit require a party seeking discovery about a settlement to make a particularized showing of relevance and that precedent and Delaware Bankruptcy Rule 9019-5(d) reflect a strong policy that confidentiality is "essential" to "promoting full and frank discussions during a mediation."[39] In light of the facts that the case was complex and involved a large media company, challenges to an $8 billion leveraged buyout, and mediation between twelve parties collectively owed billions of dollars, the court determined that the DCL Plan Proponents' proposal was reasonable and "an appropriate balance between allowing discovery of potentially relevant information and protecting the confidentiality of the mediation."[40] The court adjusted the proposal, however, to protect communications between or among mediation parties concerning the mediation to the extent the communications were exchanged on a mediation day only if the communications were between mediation parties who were present at the mediation or participated remotely.[41]

Finally, the court concluded that the appropriate start date for the discovery was the date of the Document Depository Order and not the earlier petition date.[42] That time frame allowed discovery as to the LBO-related settlements, while limiting the burden and expense of timely completing discovery.[43] The court rejected the Noteholders' contention that they should have full discovery of all settlement discussions that occurred during the Debtors' chapter 11 case because the LBO settlement was a part of plan confirmation.[44]

37 Id. at *25.
38 Id. at *28.
39 Id. at *28-30.
40 Id. at *31-32.
41 Id. at *32.
42 Id. at *35.

Accordingly, the court granted in part and denied in part the motion to compel. The court concluded that the common interest privilege applied to communications the DCL Plan Proponents shared in furtherance of their common interest after October 12, 2010 (or September 27, 2010 for the Debtors and two lenders). The Noteholders could not discover, *inter alia*, communications between a mediation party and the mediator, communications between or among mediation parties who were present or participating off-site in mediation with the mediator, and communications showing the substance of the mediation discussion. The Noteholders could, however, seek discovery of information since December 15, 2009.

Echoing the *Leslie* Court's refusal to issue a black-line rule, the *Tribune* Court cautioned against a broad reading of its decision and advocated a fact-specific inquiry with respect to the common interest privilege:

> A determination involving whether a community of interest privilege applies is an intensely fact-and-circumstance-driven exercise. The balancing of tensions which arise during the search for truth may, depending upon the particular circumstances involved, fall either way. Guided by Circuit precedent, other persuasive decisional law, applicable local rule, and orders governing mediation, I have decided that the matter before me involves circumstances warranting a determination that a community of interest privilege may be invoked by co-proponents of a plan. This is not to say that parties who are co-proponents of a plan or parties who reach settlements arising from mediation are always entitled to assert this privilege. Neither should it be said that the privilege can never be invoked unless the circumstances involve the proposal of a joint plan or a settlement resulting from mediation.[45]

43 Id.
44 Id. at *33.
45 Id. at *35-36.

Interest Privilege *continues from p. 21*

Thus, pursuant to the *Tribune* opinion, parties who engage in mediation that leads to a bankruptcy plan, the terms of which include settlement of litigation among them, may share a common legal interest in obtaining court approval of that plan and the settlement embodied in it. As a result, the common interest privilege will apply to protect the communications the parties exchanged in furtherance of their common legal interest from discovery of proponents of a competing plan.

Conclusion

Leslie and *Tribune* clarify that a complete alignment of interests among the parties exchanging documents or communications is not necessary to satisfy the common interest privilege. A shared interest in maximizing the debtor's asset pie, despite competing interests in how that pie is distributed, merited protection under the privilege in *Leslie*, while a shared interest in obtaining court approval of a proposed litigation settlement and plan of reorganization following mediation warranted protection in *Tribune*. ■

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