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Anatomy of the "100 Cent+" Case

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Recovery to common equity holders in a bankruptcy is rare. Yet there have been numerous bankruptcies where equity holders obtained not only a recovery, but a substantial one. These were cases in which all creditors and preferred shareholders recovered 100 cents on the dollar. More importantly, common equity holders received a substantial ownership interest in the reorganized entity. We call these the "100 cent+" cases — a "black swan" in the world of corporate bankruptcies. So what's different about these cases? Are they merely random events, or is there more to it?

This topic has always been of great interest, not only to academics and professionals in the field of bankruptcy and restructuring, but also to investors. Distressed investors often buy stock in bankrupt companies in hopes of a windfall, while incumbent activist investors do everything possible to retain their interests. When General Growth Properties filed for bankruptcy in early 2009, Pershing Square Capital Management, a "deep-value and activist-oriented" hedge fund[1] that owned 25% of GGP, tried to make a case as to why that was not a typical bankruptcy in which existing equity gets wiped out. It did so primarily by drawing parallels to three other large public company bankruptcies in which equity holders kept substantial ownership interests.[2]

Attributes of 100 Cent+ Cases

So what are the attributes of a 100 cent+ case? To arrive at a clear picture, we did three things. First, we defined a 100 cent+ case as one in which equity holders were awarded more than one-third of the reorganized entity's equity. We ignored cases where equity holders received only warrants and/or cash payouts, because these are often de minimis. We also limited the scope to bankruptcies filed during or after 2005. Second, we developed the shortlist of 100 cent+ cases based on our knowledge, input from industry professionals and results from news and database[3] searches. Last, we analyzed the seven bankruptcies that met our 100 cent+ criteria to determine common key attributes (See Exhibit 1 on p. 2).

We found that these 100 cent+ cases consistently shared the following three attributes:

- The debtors had a strong underlying core business prior to filing for bankruptcy.
- Bankruptcy was caused in part by a shift in an external value driver.
- There was at least one shareholder advocate throughout the course of the bankruptcy proceeding.

It's important to stress that we are not trying to claim that these three attributes have a causal relationship with a 100 cent+ recovery. We made no effort to isolate these attributes from other possible influencing factors such as the macroeconomic environment, the attractiveness of different industries, the quality of management, or luck.

Strong Underlying Core Business Prior to Filing

Even without adjusting for potential value erosion from noncore businesses or unfavorable one-time events, almost all of the debtors on our list had a positive tangible book value (i.e., equity) and a positive or break-even cash flow before debt service in the year immediately preceding the bankruptcy filing. But there was something else that really set these 100 cent+ cases apart.

In all cases, the debtors had a core business that was a leader in an industry or had a specific industry niche. ASARCO had a 109-year history as a leading producer of copper. Hancock was the second-largest fabric retailer in a highly fragmented market.[4] Blast had a niche in satellite communication services to oil and gas producers. Flying J had a thriving retail truck stop business. GGP was the second-largest operator of shopping malls, with occupancy ranking among the top of its peer group. Pilgrim's Pride was one of the largest producers of chicken in the United

1 Per hedgetracker.com.
2 Pershing Square Capital Management, L.P. "The Buck's Rebound Begins Here," Sohn Conference, May 27, 2009.
3 Special thanks to Lynn LoPucki, Professor of Law, UCLA Law School, for access to the UCLA-LoPucki Bankruptcy Research Database. Thanks also to Andrew Wood, student, UCLA Law School, for sharing data related to his research.

4 Wal-Mart Stores, Inc. (which had a fabric department in most of its stores) and Jo-Ann Stores, Inc. were the only other large fabric retailers; there were numerous smaller fabric chains and independent fabric and quilting stores.

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Letter from the President

Stephen Darr, CIRA, CDBV
Mesirow Financial Consulting LLC

Get ready for the next annual conference! On September 26, 2011, we had the initial planning meeting for AIRA's 28th Annual Conference at the conference hotel, the Grand Hyatt San Francisco. About 40 individuals were in attendance physically or by conference call including several officers and directors. Two conference co-chairs were selected—Brian Choe (Alvarez & Marsal) and Matt Pakkala (FTI Consulting)—and a third will be announced soon.

The proposed conference program is a panoply of developments and issues that will be important to the bankruptcy and restructuring profession throughout the coming year. We plan to have presentations on emerging "hot" issues, such as Cyber Terrorism/Security; Online IP Issues; Duties of Directors in the Face of Financial Distress; International Insolvency: Reverse Mergers; Foreign Exchange/Volatility Issues in Restructuring; Article 9 Sales in Lieu of Section 363; Monetary Policy; Digital Death: Distress in Media Industries; Significant Litigation and Practice Changes; and many more. Work is in process to locate keynote speakers and the schedule of topics will be finalized next week.

Generating a list of possible social activities was no problem for a destination city like San Francisco. The Presidio Golf Course, a National Historic Landmark, was hands-down the #1 option for golf on Thursday afternoon, June 7. Opened for public play in 1996 as part of the Base Realignment and Closure Act, the course was operated for the military for over 100 years by the private Presidio Golf Club (est. 1895). On Friday, June 8, there will be a pregame party before the Giants and Rangers MLB game at AT&T Park. A Napa Valley wine tasting tour will take place on Saturday, June 9.

The newly transformed Grand Hyatt San Francisco offers completely redesigned guestroom suites with "avant-garde" amenities and its renovated meeting spaces have been enhanced with technological upgrades. All the delights of San Francisco beckon just outside the doors of this ideally located Union Square hotel, including world-class shopping and dining, Chinatown, museums, the theater and many famous landmarks.

I hope you are making plans to attend AIRA's 28th Annual Bankruptcy & Restructuring Conference, June 6-9, 2012. I look forward to seeing you there.

Best Regards,

Steve

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States, Mexico and Puerto Rico. Finally, Saratoga Resources had valuable oil and gas reserves.

It is true that bankruptcy provided the debtors with the ability to shed noncore assets and improve their strategic and financial position. We would argue that this was possible only because each had a solid core business to begin with and therefore a reason to exist.

Shift in an External Value Driver

In the seven 100 cent+ cases we studied, bankruptcy was caused partly by a shift in an external value driver that was beyond the debtor's direct control.[5] Significant unfavorable shifts in commodity prices, be it the low price of copper in the case of ASARCO, the decrease in the price of oil and gas in the case of Flying J, or the increase in corn and soybean meal prices for Pilgrim's Pride, moved companies to the brink. In the case of Saratoga Resources, the drop in the price of oil, exacerbated by the damage and interruptions in production after Hurricanes Gustav and Ike, necessitated the filing. GGP was negatively influenced by plummeting commercial property cash flows, and hence, falling asset values in a tight credit environment. Hancock's core value driver was customer demand for fabric, which had declined considerably in the years leading up to the company's bankruptcy — so much so that even Wal-Mart started phasing out fabric from its stores around the time Hancock filed for bankruptcy.

It is important to note that since these shifts in external value drivers were beyond the debtor's control, a successful reorganization hinged on one of two things. Either the unfavorable shift reversed over time, or the debtors had a credible plan to quickly deal with the shift. In all cases except Hancock and to some extent GGP, the core value drivers showed signs of improvement over the course of the bankruptcy process. For example, because of improved cash flow resulting from higher copper prices, ASARCO did not even draw on its debtor-in-possession facility. Hancock closed its unprofitable stores, unlocked liquidity from favorable leases on those stores, remodeled many of its other stores, and enhanced its online presence. GGP was able to spin off its noncore holdings, which were made up primarily of master-planned communities and development parcels, to focus on its core regional mall business.

Shareholder Advocacy

Shareholder advocacy was a critical feature in the seven 100 cent+ cases we studied. In four of them, an Official Committee of Equity Holders was appointed. In the other three cases, equity holders remained in control and assisted with the restructuring. With or even without an Official Committee of Equity Holders, key shareholder advocates participated actively and vigorously in all cases to maintain ownership and control of the entity upon its emergence. Pershing Square Capital Management was not only an ardent shareholder advocate, but also a major equity contributor to the reorganized GGP. ASARCO's parent, Grupo Mexico, displayed the same level of fervor, putting forth a competing plan of reorganization that was ultimately approved by the court. In the Flying J case, the equity owners worked tirelessly to sell key assets in order to repay creditors and retain important assets around which to reorganize. In the Saratoga Resources case, an Official Committee of Equity Holders negotiated with

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5 These shifts may have been coupled with suboptimal investments, myopic long-term plans, or other factors that might lead to a bankruptcy filing.

Exhibit 1: List of Cases Included in This Study

The following cases met our 100 cent+ criteria:

$ in Millions					Financial Data*	
Debtor	Case #	Date Filed	Date Emerged	% Equity Ownership in New Stock	Tangible Book Value	Cash Flow Before Debt Maturities
ASARCO LLC (ASARCO)	05-21207	8/9/2005	12/16/2009	100.0%	NA**	NA**
Blast Energy Services, Inc. (Blast)	07-30424	1/19/2007	2/27/2008	100.0%	0	1
Flying J, Inc. (Flying J)	08-13384	12/22/2008	7/9/2010	100.0%	NA**	NA**
General Growth Properties, Inc. (GGP)	09-11977	4/16/2009	10/21/2010	100.0%***	1,121	3,383
Hancock Fabrics, Inc. (Hancock)	07-10353	3/21/2007	7/22/2008	100.0%	49	(1)
Pilgrim's Pride Corporation (Pilgrim's Pride)	08-45664	12/1/2008	12/10/2009	36.0%	284	1,641
Saratoga Resources, Inc. (Saratoga Resources)	09-50397	3/31/2009	5/14/2010	100.0%	33	8

Source: Certain financial information provided by Capital IQ, Inc.

Notes:

*Financial data reflects the debtors' financial results for the fiscal year-end immediately preceding the debtors' filing.

**NA refers to data that was not available through public sources.

***The equity holders of General Growth Properties, Inc. received 100% of the new entity as well as 9.8% of a new spinoff entity . This is by no means an exhaustive list. There may be other such cases, large and small, that meet our criteria. However, the presence of all three attributes in the cases listed above leads us to hypothesize that the same attributes or some variation thereof will be present in other cases as well.

Executive Director's Column

Grant Newton, CIRA
AIRA Executive Director

I am writing this letter just after returning from the National Conference Bankruptcy Judges in Tampa. From my perspective, it was an outstanding conference. Approximately 2,000 were registered for the conference including a large number of AIRA members. Considerable discussion focused on a number of key issues: the expected level or (lack thereof) of bankruptcy and restructuring activity for the profession during the next year, municipal bankruptcies, Stern v. Marshall, to mention a few.

This was the 4th year AIRA has hosted the opening reception for the NCBJ. This year's reception took place at the Rotunda and Riverwalk of the Tampa Convention Center; I was highly pleased with the venue and impressive turnout. We are grateful to the following firms for their sponsorship of the Opening Reception:

BDO Consulting	CBIZ	Deloitte.	FTI Consulting	Grant Thornton
Mesirow Financial Consulting	KPMG	Protiviti	RSM McGladrey	PwC

AIRA also hosted the Friday morning Breakfast Program, "Financial Advisors in the Courtroom." We appreciate the contributions of Moderator Chris Myers (Partner, Squire Sanders & Dempsey LLP) and panel members James Feltman (Senior Managing Director, Mesirow Financial Consulting), James Fox (Principal, Glass Ratner), and Paul E. Harner (Partner, Latham & Watkins, LLP). The focused questions asked by Chris Myers stimulated a lively discussion. The session will be available in November as an AIRA self-study course qualified for one hour of CPE credit.

AIRA is in the process of planning a series of Webinars for 2012. If you have a topic to suggest or would like to participate as a speaker, please send an email to gnewton@aira.org.

Finally, I am pleased to announce that Ed Ordway (Senior Managing Director, Capstone Advisory Group, LLC) and David Bart, CIRA (Director-Financial Advisory Services Group, RSM McGladrey) have been accepted into the AIRA Board of Directors. Each will serve a term of three years and I look forward to working with them.

Wishing you a great Fall season,

Grant

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management, lenders and the Official Committee of Unsecured Creditors to find a resolution that the court could approve.

Conclusion

The realization of a 100 cent+ outcome in any bankruptcy case is a rare achievement. Undoubtedly, such success does not happen by accident. Many factors may influence the outcome in a bankruptcy case. Such factors may include the ability to restructure debt or obtain additional financing, the presence of an active Official Committee of Unsecured Creditors, successful outcomes of negotiations with labor unions or the favorable settlement of significant litigation or environmental liabilities. Taken in isolation, the presence of one of these factors may lead to a successful result in a bankruptcy case and, if multiple such factors are present, the result may be quite favorable.

Although correlation does not imply causation, our research suggests that the outcome of a 100 cent+ recovery is really the product of more than just the random occurrence of any of the factors listed above. A strong underlying core business is vital for the realization of such a positive outcome, particularly in this last restructuring cycle where asset values have been extraordinarily depressed. Shifting external factors can either cause or assist the recovery from financial distress. We certainly noticed these in each of the cases referenced above. The bigger factor was the skill and agility with which management of such business responded to such shifts in the external operating environment. Finally, advocating shareholders, being either existing management or external equity holders, are usually the driving forces behind a 100 cent+ recovery. Many cases have realized substantial recoveries of less than 100 cents, because there was not an active advocate driving that final five to ten percent recovery. The existence of such a catalyst seems to be required in achieving such an extraordinary result. ■

With special thanks to Brian Bonaviri, Senior Associate, for his contribution.

Note—Grant Thornton's Corporate Advisory & Restructuring Services (CARS) practice recently announced that Managing Partner Loretta Cross and Principal James Peko have been awarded the Certification in Distressed Business Valuation (CDBV) accreditation by the AIRA. The CDBV certification attests that Loretta Cross, a founder of Grant Thornton's CARS practice, and James Peko are qualified in the valuation of distressed assets, including those of distressed or bankrupt companies.

Forensic Accounting to the Rescue

Phil Goy, CIRA
BBK Managing Director, Finance and Restructuring Consulting

Somewhere beneath the surface of a troubled company the real story may be waiting to be discovered and forensic accounting can bring it to light.

While restructuring specialists are putting out fires, forensic accountants take a more in-depth look. They follow a problem to its source—wherever the trail may lead. The root cause may turn out to be nothing more than the financial struggle that a company has endured. However, it is also possible specific individuals or issues may be to blame or bear some financial responsibility for a company's problems.

In the worst cases, individuals may have diverted or stolen company property or set up kickback schemes to benefit personally. They may also fraudulently deny they have assets to avoid having to support loan guarantees, even though ample funds or property may be in their possession.

Once recovered through court action or other measures taken by those individuals or entities that have suffered losses, the assets in question can help ease the path to a company's revival as a going concern or its orderly shutdown. Whatever their results, forensic accountants are ready and able to present their findings to courts of law and provide expert testimony on their investigations.

In many troubled firms, human frailty is clearly a factor. Business owners, often optimists by nature, may have pushed their financial commitments too far when they originally applied for their loans. In their business operations, they have to keep a lot of balls in the air, and the distinction between personal and business property may become blurred.

If there has been fraud, it probably started off small—a ream of office paper or a package of pens, perhaps—and then escalate to tens of thousands of dollars. The sum may even rise into the millions, as headlines over the last decade have made clear.

We've all heard the stories: executives of a publicly-traded company steer millions of dollars into the top executives' private business ventures and covered up the transfers with fraudulent financial entries. A purchasing agent accepts a small increase in the price of the part in return for a kickback from a vendor. A public firm hides its massive indebtedness in off-balance-sheet (so called "special purpose") entities.

At times, our credulity is tested by an owner's or executive's capacity to delude himself about the value of his personal expenditures to the company—like a million-dollar purchase at company expense, even at the height of economic woes.

The risks of fraud increase in tough times, testing the scruples of owners, managers and employees alike. The incidents are more common and more costly to companies than people might think. The average losses are 5 percent of an organization's budget, according to an international study published by the Association of Certified Fraud Examiners (ACFE) in 2010.

As might be expected, the higher the standing of individual in the organization, the greater the losses, according to the ACFE report. In its study of 968 fraud cases in the U.S., owners and executives were responsible for average losses of $485,000. The figure was $50,000 for employees and $150,000 for managers.

Tipsters, often over a hotline, are a major source of information about these crimes. They account for about 40 percent of fraud detection, often uncovering information that standard audits and reviews fail to detect. However, there is another set of worrisome statistics from the ACFE as the fraud may have gone on for quite a while before discovery. According to the ACFE, financial statement fraud continues for an average of 27 months, and check tampering continues for 24 months.

All this suggests a degree of wrong-doing that may often go unnoticed in at least some companies. One shudders to think about its extent in companies that have never bothered to set up hotlines—or have never brought in a forensic accountant.

In certain circumstances, forensic accountants may be able to identify an extra avenue or opportunity for re-paying creditors or others harmed in the collapse of a company. It's not always easy since "almost all fraud involves the attempted concealment of the crime," as the ACFE points out.

It's easy to understand why troubled companies and their stewards may not think they have the luxury to chase down every conceivable forensic issue. After all, they deal with matters of the highest urgency: layoffs, firings, management shuffles, negotiations with creditors, owners, suppliers and other stakeholders. With a company in dire straits, the responsible parties may simply want to get through insolvency or restructuring as quickly and inexpensively as possible.

But enlisting the services of a forensic accountant can have a direct influence on the process, whether by uncovering diverted assets or identifying problems that can be remedied. Forensic accounting can also lay the groundwork for a lawsuit to recover assets when someone is to blame for the problem. Indeed, "forensic" basically refers to evidence suitable for use in court.

BBK recently handled a case involving personal loan guarantees. In these situations, it's important to determine whether a borrower has the resources to make good on them. But the determination can be complicated by the fact that people often transfer assets as part of their estate planning. A forensic accountant may need to perform due diligence on these transfers. Have all the gift tax returns been filed with the Internal Revenue Service? Has all the paperwork been completed? If not, the lender may rightfully claim all or part of the assets.

In our case, a borrower had problems repaying a loan and claimed an inability to pay. Our investigation uncovered suspicious-looking cash transfers to family members and the borrowers' own cash transactions. We were able to determine that there were in

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fact resources available to perform on the loan guarantee. The result was that the lender was able to make a significant recovery. Without a forensic investigation, a favorable outcome could not have been achieved.

Forensic accounting isn't just appropriate in restructurings. In the banking sector, a little forensic-style investigation would have been welcomed back at mid-decade as the U.S. real estate bubble inflated and before it collapsed a few years later. Many a loan turned out to be less safe than the banks had thought, as personal worth—especially in the form of real estate—declined. A borrower worth millions on paper in 2005 could ultimately have been worth a fraction of that figure. It would have been a huge help to banks, and the economy in general, if more of these problems had been identified early on.

Of course, it's not always a comfortable feeling to be at other end of a forensic accountant's microscope. The investigation starts out with a deep-dive into the company's financial records practices. The goal is to become very familiar with how items are recorded. Once forensic accountants are familiar with them, the anomalies may stand out. They can "interrogate" the documents further or seek explanations from owners, executives or employees.

Yet they don't merely rely on their own experience and instincts. They resort to special tools, and they don't hesitate to develop manual and computerized applications themselves. In general, these tools automate the process of identifying anomalies.

Something as straightforward as an Excel spreadsheet can be customized into a powerful tool to interrogate a company's financials. Once anomalies are identified, forensic accountants can delve into the financial records and take a closer look. They might well find that an outsized or unusually timed expenditure on office supplies, or another commodity, masks embezzlement or other fraud.

The laws of statistics help as well. The truth is that, mathematically speaking, it's not that easy to falsify data in a believable way. Recurring patterns occur in many real-world data sets, and deviations from them may suggest errors or tampering. Physicist Frank Benford discovered the phenomenon bearing his name early in the 20th Century. It has to do with the recurring frequency of certain digits in data sets—first and foremost the digit "1." Accountants began putting "Benford's Law" into practice in the 1970s, identifying anomalies that were otherwise opaque to normal scrutiny. This may be applied to figures relating to payroll, purchases, investments and other items as well as other statistical testing methodologies.

The work of forensic accountants doesn't stop at the discovery of fraud or the identification of assets that may rightfully belong to a company. Before or during litigation, they prepare and submit formal reports of their findings for courts of law, and give expert testimony themselves. They are careful to nail down their information and tie all the loose ends together, knowing that it could be subjected to withering scrutiny from attorneys on the other side of the table.

When it all comes together, the determination could be that someone is to blame for the plight of a company, or that it has simply fallen on hard times, or the answer could be somewhere in-between. Even then, it is a huge service to identify the root cause of a problem and the responsible parties; and that alone is a great source of satisfaction. In any event, forensic accounting is closing the loop on a crime that costs businesses worldwide an estimated $3 trillion annually, according to the ACFE. ■

Bankruptcy Valuation

Kenji Mochizuki, CIRA
Lecturer, University of Pennsylvania

CAPITAL ASSET PRICING MODEL: PART 1 RISK FREE RATE

This column recently discussed the market approach to bankruptcy valuation. We will now consider the income approach. In addition to the Discounted Cash Flow (DCF) method, the income approach also encompasses such alternatives as the Adjusted Present Value (APV) method, the Capital Cash Flow (CCF) method, and the Weighted Average Cost of Capital (WACC) method. Although these methods differ in how the cash flows are calculated, all of these methods require a discount rate to calculate the present value of those cash flows.

Typically in bankruptcy valuation, the Capital Asset Pricing Model (CAPM) is used to estimate the discount rate. Over several future issues of the AIRA Journal, this column will discuss each of the CAPM components.[1] In the original model of the CAPM, the expected return on an individual security, E(R), is equal to the risk free rate, or the rate of return available on a risk free security as of the valuation date, Rf, added to the product of the systematic risk of a company in relation to the market as a whole, β1, and the equity risk premium for the market, RP1. This last term is the difference between the Rm and the Rf.

$$E(R) = Rf + \beta 1 \times RP1$$
$$E(R) = Rf + \beta 1 \times (Rm - Rf)$$

To value smaller businesses, the Modified CAPM (MCAPM) includes a small stock equity risk premium for small business size, RP(s), as well as a company specific equity risk premium for unsystematic risk, α. This alpha risk can include such items as changing technology, regulatory change, pending litigation, customer concentration, and dependence upon a key person or key supplier.

$$E(R) = Rf + \beta 1 \times RP1 + RP(s) + \alpha$$

Lack of Guidance

We begin with the risk free rate because it is perhaps the most ignored and least understood CAPM input. The risk free rate is not an active area of academic research and the few papers published on this topic are typically several decades old. The most recent spate of academic papers related to the risk free rate was in the 1980s. Most popular finance textbooks devote little space to the risk free rate. Even specialized books on the cost of capital (rarely required reading for students in MBA or even Ph.D. in finance programs) contain only one or two pages at most on the risk free rate. Thus, there is often a shortage of preparation for financial professionals on how to select and estimate the risk free rate.

The Certified Insolvency & Restructuring Advisor (CIRA) Part 2 curriculum on the DCF method limits its discussion of the risk free rate to one paragraph. Mentioned are several key issues about the risk free rate, e.g. real vs. nominal rates, the meaning of "risk free," the different types of risks, and the investment time horizon. In Chapter 1, Determination of Reorganization and Liquidation Values, we read that:

The first component of the equation is the risk-free rate. The risk-free rate consists of the real interest rate plus an allowance for expected inflation. There are no 'pure' risk-free securities in the U.S. While it may be claimed there is no default risk in government securities, long-term treasury bonds are subject to capital losses if the interest rate rises. While a pure risk-free rate cannot be found, most practitioners use the rate on long-term treasury bonds as a proxy for expected inflation. The time period for the treasury bonds should approximate that used for the projection period.[2]

This article begins a series to discuss in further detail these and other issues. However, the efficient market hypothesis, portfolio risk and return, security market line, and other topics of modern portfolio theory that are the foundation of DCF and CAPM will not be included in the scope of the current discussion.

Risk Free Rate of Return

Briefly, the risk free rate is the rate of return available in the market on an investment that is free of default risk at the time of the analysis.[3] In common practice, this is usually the yield to maturity on a U.S. government security, which is a nominal rate that includes expected inflation.

The risk free rate is often perceived as the theoretical rate of return of an investment with zero risk (the various risks and the meaning of "risk free" will be discussed in detail in the next installment). The risk free rate is the minimum return that would be demanded by a hypothetical risk adverse investor because he or she would not accept additional risk unless the potential rate of return is equal to or greater than the risk free rate.

Thus, the risk free rate functions as the baseline of comparison for competing investment opportunities. It is the default investment decision a risk adverse investor will normally make unless induced by higher returns elsewhere (a future article on the equity risk premium (ERP) will discuss this further).

Other Uses of the Risk Free Rate

In addition its use in the DCF method that is well accepted by the bankruptcy courts, the risk free rate is also a required input of various other valuation methodologies. In addition to the CCF and WACC methods, there are two others that should be highlighted:

1) Arbitrage Pricing Theory (APT)[4]—The APT is an alternative asset pricing model involving multiple factors and more flexible assumption requirements. Finance courses often teach the following points about APT: (1) it extends the concept of CAPM by including more than CAPM's one factor—the market, systematic or undiversifiable risk (see formulas, where RP is the risk premium of the factor and rf is the risk free rate); (2) both the CAPM and APT are one-period models that assume a linear relationship between the expected return and its covariance with the factors; (3) CAPM uses an asset pricing model based on investors' portfolio demand and equilibrium arguments, whereas the APT uses a factor model of asset returns involving arbitrage

1 CIRA Study Course Part 2: Plan Development, Revised 4/21/11 (The Association of Insolvency and Restructuring Advisors, ©2009)

2 *Ibid*.

3 Cost of Capital: Applications and Examples, by Shannon P. Pratt and Roger J. Grabowski (Wiley, ©2008).

4 Hitchner, *op. cit*.

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portfolios. Because the APT may reduce to the CAPM in a special case, the CAPM can be thought of as a special case of APT when there is only one risk factor (this is not quite true since unsystematic or residual or company specific risk was ignored).

CAPM: $E(R) = Rf + \beta 1 \times RP1$

APT: $E(R) = Rf + \beta 1 \times RP1 + \beta 2 \times RP2 + \beta 3 \times RP3 + \ldots + \beta n \times RPn$

The greatest problem of the APT is the lack of factor specificity.[5] The theory itself does not specify the multiple factors which systematically affect security returns. Thus, we have to construct the factors empirically through data mining, statistical analysis such as factor analysis, and use of macroeconomic variables.[6] Examples include the Gross National Product (GNP), interest rates, and inflation. Because these factors end up being defined somewhat arbitrarily, this creates the yet unsolved challenge of finding statistical significance for a practical application of the APT.

The CAPM has several weaknesses that the APT attempts to overcome. However, despite its attractiveness, the APT is not widely applied. Ultimately for bankruptcy professionals and valuation consultants, the APT is seldom used in cost of capital determinations because of the above lack of usable data for the model components.

2) Black-Scholes option pricing formula[7]—This is used in the real options approach, where the risk free rate is one of five inputs. This approach treats a firm as analogous to a call option. The formula[8] expresses the value of that call option (C) in terms of the current underlying asset price like that of a stock (S); the exercise price of the option (X); the volatility of the underlying stock, that is, the standard deviation of the rate of return of the stock (σ is included in both d1 and d2); the short term risk free interest rate (r); and the time period to expiration of the option (t):

$$C = S \times N(d1) - Xe\text{-}rt \times N(d2)$$

Brief review of stock options: An option is a financial contract that gives an investor the right, but not the obligation, to buy an underlying asset at a specified price within a specified time period. A call option allows the investor to buy the underlying asset, whereas a put option allows the investor to sell. An American call option can be exercised at a fixed strike price anytime before the expiration date of the option, whereas a European call option can only be exercised at the expiration.

These describe a financial option involving financial instruments like stocks and bonds, whereas a real option pertains to projects with a put or call option involving real assets. With a real option, an investor or manager has the option to choose between two distinct investments where both choices involve tangible assets. Unlike a financial option, a real option has nothing to do with an option contract, and the option to make a capital investment or capital budgeting decision is not tradeable to another investor or manager.

In the Black-Scholes option pricing formula, the appropriate rate to use is the risk free rate over an interval corresponding to the option exercise time.[9] Often this is approximated by using rates paid for U.S. Treasury bills, matching the length of the option maturity to the U.S. Treasury bill period. There is an opportunity cost associated with the initial investment, which is tied up from the expenditure date through the exercise time. Thus, an investor must be compensated for what has been forgone or what could have been obtained from an alterative risk free investment.

The Black-Scholes formula can be used to value pharmaceutical, energy, mining, entertainment, and real estate companies. Developing a new drug, drilling for oil or gas, mining for metals or minerals, producing a feature film, owning a parking lot with development options are all projects with optionality. The corporate valuation considers the company to be a portfolio of such projects with American option-like features. For example, a drug development project can be abandoned at any time, which amounts to a put option.

The Black-Scholes formula is also used in the valuation of intellectual property.[10] This approach incorporates the value associated with the uncertainty inherent in a business and the active decision making required for a patent-based business strategy to succeed. The underlying asset value is the present value of the intellectual property's future cash flows over the life of the asset. The exercise price is the present value of the fixed costs that must be invested to commercialize the product or to maintain the patent's strength. The time is the period remaining until the patent expires. The volatility is the standard deviation of the growth rate of the patent's cash flows. The risk free rate is the risk free U.S. Treasury rate over the remaining life of the patent.

Real or Normal Rate

Financial news often mentions nominal and real wages, nominal and real interest rates, as well as nominal and real Gross Domestic Product (GDP) growth. In this section the differences between real and nominal are described along with a discussion of when to use real and when to use nominal rates,

In economics, a change over time in the nominal value of some commodity bundle can be due to a change in the quantities in the bundle or their associated prices. A change in real value reflects only changes in quantities, not in prices. Real value adjusts nominal value to remove effects of price changes over time, e.g. due to the effects of inflation. Thus, a real variable accounts for the effects of inflation, whereas a nominal variable does not.[11]

The Fisher equation is an easy way to remember this often confusing economic concept. It shows the relationship between the nominal interest rate (i), the real interest rate (r), and the inflation rate (π):

$$\text{Nominal interest rate} = \text{Real interest rate} + \text{Inflation. } (i = r + \pi)$$

The equation can also be rewritten in the following manner:

$$\text{Real interest rate} = \text{Nominal} - \text{Inflation. } (r = i - \pi)$$

Similar to the interest rate, the risk free rate is available in real or nominal terms.[12] The nominal risk free rate includes expectations for inflation, compensation for postponing consumption, and the

5 Porras, *op. cit*.

6 web.mit.edu/15.407/file/Ch12.pdf.

7 The Cost of Capital, by Eva R. Porras (Palgrave Macmillan, ©2011).

8 Financial Valuation: Applications and Models, by James R. Hitchner (Wiley, ©2006).

9 *Ibid*.

10 http://faculty.darden.virginia.edu/chaplinskys/PEPortal/Documents IP%20Valuation%20F-1401%20_watermark_.pdf

11 The Cost of Capital: Theory and Estimation, by Cleveland S. Patterson (Quorum Books, ©1995)

12 Porras, *op. cit*.

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interest rate risk. The real risk free rate adjusts the nominal risk free rate by removing the effects of expected inflation.

In a simple world with no taxes, no inflation, and no uncertainty in future investment payoffs, the real risk free rate reflects the price that investors charge to exchange current consumption for future consumption. The real risk free rate is determined by the availability and nature of investment opportunities as well as the subjective preferences of investors. The real risk free rate is roughly 0% to 5% in most developed countries, although it is difficult to infer either its level at any point in time or its average value over longer periods.[13]

The nominal risk free rate is the rate that can be observed and estimated in the capital markets. The closest approximation to the nominal risk free rate is the annualized yield to maturity (YTM) on discount U.S. government bills or bonds, although these are not wholly risk free in the presence of uncertain inflation and fluctuating interest rates. Recall that the yield to maturity on a U.S. government security is a nominal rate that includes expected inflation.

Some argue that real risk free rates should be used instead of nominal risk free rates because investors actually receive the real rate of return. Others argue that nominal risk free rates are appropriate since investors compare investment opportunities using nominal rates of return. This is referred to as interest rate illusion.[14] This issue will be discussed in a future article on the equity risk premium (ERP), since the risk free rate is used to calculate the ERP.

In conclusion, the risk free rate should include expected inflation. Since most prefer to use a U.S. government security that includes expected inflation, the nominal risk free rate is typically used. Because the nominal risk free rate includes inflation, when discounting net cash flows at this rate, it is necessary to state cash flows in nominal values.[15]

Take-Home Messages

- The risk free rate (rf) is the minimum return an investor expects because the investor will not accept additional risk unless the potential rate of return is greater than the risk free rate.
- Normally the nominal risk free rate is used, which includes expected inflation. The nominal risk free rate is equal to the risk free rate plus the inflation. The real risk free rate is equal to the nominal risk free rate minus the inflation.
- The risk free rate is one of the key CAPM inputs to calculate the cost of equity and to derive the discount rate used in the DCF method. However despite the wide acceptance of the DCF method in bankruptcy valuation, the risk free rate is perhaps the most ignored and least understood input.
- Additionally, the risk free rate is an input related to several other bankruptcy valuation methods, including the Black-Scholes option pricing formula, the Arbitrage Pricing Theory (APT), the Capital Cash Flow (CCF) method, and the Weighted Average Cost of Capital (WACC) method. ■

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13 Patterson, *op. cit*.
14 Porras, *op. cit*.
15 Porras, *op. cit*.

Bankruptcy Taxes

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FIGHTING IRS ON PAYROLL TAX TRUST FUND PENALTIES

An interesting discussion recently appeared in the ABA TAX Listserv, a free internet site open to the public, on using Freedom of Information Act requests and other techniques to fight IRS assessments of the 100 percent penalty for failure to deposit payroll taxes. Internal Revenue Code Section 6672 permits a 100 percent penalty to be assessed in the case of federal income tax withholding and employee FICA which is not remitted to the IRS. This penalty, known as the Trust Fund Recovery Penalty (TFRP) or the 100 percent penalty is assessed against the individual determined by the IRS Collections Revenue Officer as the "responsible person" and that person can be as low in an organization as a bookkeeper. Because those taxes are withheld from employees' pay, when they are not deposited with the IRS, there is a presumption that someone made a conscious decision to use the money for other purposes, thus IRS recovers it from the person they determine to be "responsible." Undeposited trust fund taxes are very common in bankruptcies and represent one of the few liabilities which often penetrate through to the individual officers or employees of the debtor entity.

The discussion indicated that these determinations are extremely fact dependent but the person assessed the penalty is rarely informed of all the considerations that went into the decision. When representing a person assessed the TFRP, several posters said that the first move should be a "Freedom of Information Act" request for the administrative file related to the assessment. That will identify

the alleged facts upon which the assessment was made and the facts which exonerated other potential responsible parties. The file shows the Revenue Officer's interview notes taken after meetings various with employees; though their names may be redacted, it may be possible to determine their identities. Also, the files may contain copies of bank signature cards and other documentary evidence gathered by the Revenue Officer during the course of the investigation.

Postings to this discussion stated there is usually a great deal of finger pointing going on during these investigations, and everybody is blaming someone else. For example, if your client was an ex-employee at the time of the investigation, his absence would likely make him the logical scapegoat for both the IRS and the other employees; however, even if you could not prove your

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client was not a responsible party, you might be able to identify somebody who should share in the liability along with your client.

If the original examination and the final assessment went unchallenged by your client there may have been a great deal of misinformation gathered by the IRS. For example, the mere fact that a signature card identified your client as "authorized" to sign checks is enough to convince a Revenue Officer that the client was responsible, even if the client never had physical access to the check book or if the office

protocol was such that your client never had the practical ability to sign checks without express direction of the higher-ups. In one case the assessment was quashed by showing that the boss required the employee to sign blank checks ostensibly because the boss needed them available "in case the employee was out of town when a check was needed."

According to the discussion posters, if the IRS cannot be convinced to drop the assessment, the next alternative is going to federal court. The taxpayer will have to pay a divisible portion of the tax and sue for a refund but there is a risk: If you sue to get a refund, the US could counterclaim—which means if the taxpayer is found responsible, the amount would be reduced to a judgment for which the statute is 20 years instead of the normal 10 years.

Here is the URL for the ABA-TAX Listserv:

http://mail.abanet.org/archives/aba-tax.html

Thanks to the posters who contributed to the discussion, including: Jane Becker, Joseph Moore, Dan Runion and John Rodgers. Thanks also to Grant Newton and Dennis Bean.

ADVISORS' TAX TOOLKIT: TAX FREE REORGANIZATION TYPES

Although the age of the C corporation may be coming to an end, legacy C corporations will be around for a long time because of the lock in effect created by the double taxation associated with C corporations—upon liquidation there is a tax at the corporate level and again at the shareholder level. The objective of this article is to provide restructuring advisors with an overview as to the major types of tax free reorganizations that can be performed with C corporations under Internal Revenue Code Section 368(a). While generally referred to by their paragraph designations—A, B, C, etc.—there are substantial differences among the tax free reorganization types. Generally, each is useful in its own special circumstances and not as useful in others.

The purpose of this article is to identify the fact situation in which each major type of reorganization is most appropriate. There are certain rules—such as the continuity of business enterprise, minimum ownership control and limitations on nonstock consideration ("boot")—that apply to most types of reorganizations, which are also discussed in this article. All of these reorganizations are useful for either publicly traded or closely held corporations.

TYPE A – MERGER UNDER STATE LAW

In this type of reorganization, usually the Target is merged into the Acquirer under state law with the Target corporate shell disappearing, accompanied by a distribution of Acquirer stock, or some combination of stock, cash or long term notes being issued to the Target shareholders. Generally there is no taxable gain recognized at the corporate level and the stock equity issued is not taxable to the Target shareholders. Cash received by Target shareholders is taxable and in some cases receipt of the long term notes is taxable. This ability to distribute cash in a Type A is highly prized because distribution of cash is very limited in the other types of reorganizations. In fact, cash can constitute up to 60 percent of the consideration distributed in a Type A. Another feature of Type A is that a Target can be merged into a disregarded entity such as a single member limited liability company of the Acquirer, if desired. One available application of this feature is a "reverse triangular merger" in which Parent stock of the Acquirer is issued and the "Acquiring" corporation is merged into the Target, with Target surviving as a subsidiary of that Parent. This is particularly useful where the Target corporation is a regulated entity such as a bank or holds special licenses or permits which must be left undisturbed.

Type A Simple Example – The shareholders of Target and Acquirer agree to merge under the laws of their state of domicile with Acquirer the surviving corporation. The Target shareholders receive stock equal to 30% of the outstanding Acquirer stock plus $100 cash. Target corporation was owned equally by two Shareholders, A and B. Shareholder A receives the new Acquirer stock and Shareholder B receives the cash and no stock. The reorganization qualifies as a Type A tax free reorganization. There is no tax at the corporate level. Shareholder A is not currently taxable and takes the Acquirer stock at the same basis as his Target stock. Shareholder B is taxed on the gain of $100.

Conclusions about Type A mergers—This is the most flexible type of tax free reorganization as substantial cash can be distributed as well as other classes of stock and long term notes, so it most closely approaches an asset purchase transaction. However, the assets acquired have a carryforward basis and are not stepped up to fair market value for tax purposes even if they are for financial accounting. Some disadvantages are that the surviving corporation may inherit tax and legal problems of the merged corporation. In order to avoid complications involving some contracts, financing arrangements, regulated entities, favorable licenses, etc. when the merged entity goes out of existence, a "reverse triangular merger" with the Target corporation surviving may be desirable.

TYPE B – STOCK-FOR-STOCK SWAP

In this type of reorganization, the Acquirer corporation receives the Target corporation stock solely in exchange for voting stock of the Acquirer. Cash, nonvoting stock, notes and/or bonds cannot be used. Many of the legacy groups of publicly traded corporations were built using this technique.

Type B Example – The shareholders of Acquirer, which happens to be publicly traded, agree to acquire closely held Target corporation by issuing 10,000 shares of Acquirer voting common stock to the Target shareholders. The reorganization qualifies as aType B tax free reorganization. The Target shareholders are not currently taxable and they take the Acquirer stock at the same basis as their Target stock.

Conclusions about Type B stock acquisitions—While this technique is useful in many situations, the restriction against using cash, nonvoting stock and notes makes it less flexible and creates higher potential for legal missteps. It does result in the Target remaining intact as a subsidiary and from that perspective helps contain any legal liability problems of the Target.

TYPE C – STOCK FOR ASSETS

In this type of reorganization the Acquirer corporation receives substantially all the assets of the Target corporation in exchange for Acquirer voting stock. This technique helps protect the

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Acquirer from legal problems of the Target because the Target corporation never merges into Acquirer, a fact which sometimes satisfies concerns expressed by the Acquirer's business attorneys. Technically, the Acquirer issues stock to the Target which then distributes that stock to its shareholders. In limited situations, cash can be part of the acquisition consideration.

Type C Example – Acquirer corporation wants to acquire the business of Target corporation but Acquirer's attorneys are concerned about possible legal liabilities from some of Target's prior activities. Acquirer issues 10,000 shares of voting common to Target which then distributes the stock to its shareholders. Target transfers all its assets to Acquirer. The reorganization qualifies as a Type C tax free reorganization. The Target shareholders are not currently taxable and they take the Acquirer stock at the same basis as their Target stock.

Conclusions about Type C stock-for-assets reorganization—This technique is useful because it also has some similarity to an asset purchase in that it limits exposure of Acquirer to Target's legal and tax problems. However, the Target assets in the hands of Acquirer have a carryforward basis and are not stepped up to fair market value for tax purposes even if they are for financial accounting. The ability to pay some cash along with the voting stock issued when circumstances permit can be desirable.

TYPE D – PREPARATION FOR A SPINOFF

A highly useful method for transferring assets to shareholders is the spinoff under IRC Section 355. If a corporation meets the requirements, it can distribute the stock of a subsidiary tax free to its shareholders. If the business to be distributed is just a division of the distributing corporation, it must be dropped down into a separate corporation in order to be distributed to the controlling corporation's shareholders. The primary requirement for a Sec. 355 spinoff is that both the distributed corporation and the distributing must have a five year active business history.

Type D Example – The shareholders of Corporation K, which has been in the retail clothing business for 20 years have decided that its Division R, a restaurant chain which it acquired five years ago, does not fit its current business plan and think Corporation K shareholder value would actually be improved if the restaurant chain were distributed to its shareholders. In preparation for a Sec. 355 tax free spinoff, Corporation K drops the Division R restaurant chain down into a newly formed Corporation R. The shares of Corporation R are then distributed to the K shareholders. The drop down reorganization qualifies as a Type D tax free reorganization and the distribution of the Corporation R stock to the K shareholders is a qualified Sec. 355 spinoff. The K shareholders are not currently taxable and they apportion some of their K stock basis to the R stock based on relative fair market values.

Conclusions about Type D spinoffs—This is an important method for distributing a business to shareholders on a nontaxable basis. Since spinoffs are a major topic in and of themselves, they will be covered in more depth in a future column.

TYPE E – RECAPITALIZATION

A recapitalization has been characterized as the "reshuffling of a capital structure within the framework of an existing corporation." Generally common and preferred stock can be issued tax free to replace or in addition to existing stock equity. Bonds (long term notes) can be issued up to the principal amount of bonds surrendered and stock can be issued for bonds surrendered. But in order to be tax free, the fair market values have to be equivalent; otherwise the corporation will recognize cancellation of debt income.

Type E Example – Corporation Z is in financial difficulty and has insufficient cash to make payments on its next bond service date. Z and its bondholders agree on a recapitalization plan in which the bondholders receive $1.5 million in fair market value in Z common stock in exchange for the $2 million of outstanding bonds. The $500,000 difference is cancellation of debt income to Z which will be tested under the usual Sec. 108 rules to see if the insolvency exception or any other favorable exception applies. The receipt of the Z common by the bondholders is not taxable and they may have a deductible $500,000 loss.

Conclusions about Type E recapitalizations—This is an important method for restructuring troubled companies but in recent years the tax law has been tightened to cause recognition of cancellation of debt income in many situations. It is now difficult to structure a troubled company recapitalization without creating at least a partially taxable transaction.

REQUIREMENTS APPLICABLE TO TYPES A - E

The primary requirements applicable to the tax free reorganizations discussed above are:

1. There must be a written plan of reorganization.
2. After the reorganization at least one historical business must continue to be operated, known as "continuity of business enterprise."
3. The transaction must have a business purpose.
4. Immediately after the transaction, the parties to the reorganization must own 80 percent of the stock of the transferee (applies to the drop down in Type D).
5. Cash received by the Target shareholders is taxable, usually without any reduction for allocation of basis.

TYPE G – TAX FREE REORGANIZATION IN BANKRUPTCY OR RECEIVERSHIP

A "G" reorganization is a transfer by a corporation of all or part of its assets to another corporation in a bankruptcy or similar case followed by the distribution of stock or securities, pursuant to a court-approved reorganization plan, by the corporation that has acquired the assets. The rules that apply to Type G reorganizations are different from those that are applicable to the other types of reorganizations discussed above. Some requirements for qualification that appear in Code Sec. 368 do not apply at all, while others have been substantially diminished in effect. In G reorganizations there are several provisions facilitating the carryforward of net operating losses and other favorable tax attributes.

Type G Example – Corporation P, which has two issues of notes outstanding, sustains substantial losses. To restructure its business, P files a Chapter 11 petition and, following approval of its plan of reorganization, forms Newco—a C corporation—into which P merges. Under the plan of merger, the holders of P's notes will receive 95 percent of Newco's stock and P's shareholders will receive the remaining 5 percent. Newco continues the business. The merger constitutes a G reorganization and there is no gain or loss on P's transfer of substantially all of its assets to Newco in exchange for Newco stock and the assumption of P's liabilities. Because P is a debtor in bankruptcy, any debt-discharge income is

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excluded from income under the §108(a)(1)(A) exception. Newco, however, must reduce its tax attributes by an amount equal to the debt discharged

Conclusions about Type G reorganizations—This is the major technique for restructuring corporations in Chapter 11 which are not going to be sold in a taxable transaction, but which are going to restructure stock and debt and emerge, sometimes with new capital from new parties. The requirements are fairly relaxed and often net operating losses can be at least partially carried forward.

SUMMARY

Acquisitive Reorganizations—If the transaction involves an acquisition, reorganization Types A, B or C can be used. Type A, the merger under state law, is the most flexible as cash, nonvoting stock and notes can be used and merger with limited liability companies or the "reverse triangular merger" technique is available. The Type B reorganization simply involving a swap of the Acquirer voting stock for the Target stock is the most restrictive and results in the Target surviving as a subsidiary of Acquirer which is desirable in some situations. The Type C stock-for-assets reorganization is useful because only the assets of the Target come over to Acquirer which reduces exposure to legal problems of the Target and cash can be used in some situations.

Spinoffs—This is a useful technique for distributing a business to shareholders on a nontaxable basis.

Recapitalizations—In a Type E recapitalization, the issuance of new stock for old and new stock or debt for old debt is basically a nontaxable transaction. In restructuring troubled companies, the equivalent fair market value rules on the debt exchange make it difficult to avoid recognition of some cancellation of debt income.

Type G Bankruptcy Reorganizations—For corporations that are going to be restructured and emerge as a stand-alone company, the relaxed requirements in comparison to other types of reorganizations facilitate the fresh start.

A Note About Private Letter Rulings

In large dollar amount deals, it is common that the parties obtain a private letter ruling from IRS that the transaction qualifies as a Sec. 368 reorganization. Small transactions are often executed without an IRS ruling which does entail some risk. I advise practitioners to always offer the client the option of going for a PLR with disclosure of the fact that it will probably cost at least $50,000 and take six months to obtain. Many times the client declines, but in the unlikely event of an adverse IRS audit, the practitioner has some liability protection from the fact that the client had the opportunity to get the assurance of a ruling from IRS but decided not to.

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

EMERGING CONSENSUS: INHERITED IRAS ARE EXEMPT

A highly contested issue in recent personal bankruptcy cases is the ability to exempt "inherited IRAs" from the bankruptcy estate, meaning that they cannot be reached by ordinary creditors. Under Section 408 of the Internal Revenue Code an individual may contribute retirement savings amounts to an Individual Retirement Account which is treated as a sort of tax exempt trust. An individual may also roll over retirement funds from an employer plan to an IRA on a nontaxable basis. When an IRA owner dies, a qualified (nontaxable) rollover may be made to certain beneficiaries, the "inherited IRA". In order to qualify, an inherited IRA rollover must be made by a direct "trustee to trustee" transfer.

BAPCPA 2005 added a paragraph to Sec. 522(d) of the Bankruptcy Code concerning the bankruptcy estate which provides:

"(d) The following property may be exempted under subsection (b)(2) of this section:

…………………..

(12) Retirement funds to the extent that those funds are in a fund or account that is exempt from taxation under section 401, 403, 408, 408A, 414, 457, or 501(a) of the Internal Revenue Code of 1986."

Some trustees argue that inherited IRAs do not contain retirement funds of the debtor, but of the original owner, thus, they do not meet the definition above and should be included in the bankruptcy estate of the inheriting beneficiary. However, the courts are basically requiring only two criteria to meet the definition in the Bankruptcy Code:

(1) the amount the debtor seeks to exempt must be retirement funds, and

(2) those retirement funds must be in an account that is exempt from taxation under one of the designated provisions of the Internal Revenue Code: i.e. section 401, 403, 408, 408A, 414, 457, or 501(a).

Numerous decisions have held that as long as the amounts in the IRA originally represented retirement funds of the owner, it does not matter that they were not retirement contributions of the inheriting beneficiary. In re Brian Eugene Johnson and Toni Palzer-Johnson, Debtors., U.S. Bankruptcy Court, W.D. Washington, 2011-1 U.S.T.C., surveying many other cases, and Chilton v. Moser, 2011 WL 938310 (E.D. Tex. March 16, 2011).

So far, the reported decisions are mostly bankruptcy court and U.S. District Court decisions: it remains to be seen what will happen as these cases get appealed up the ladder.

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

IRS TIPS FOR BANKRUPTCY TRUSTEES

The IRS website provides the following helpful information for bankruptcy trustees who receive IRS Collection notices:

If the IRS is a creditor in a bankruptcy case and it is determined that the IRS was not originally listed as a creditor, notification of the filing should be sent to the IRS in order to prevent violations of the automatic stay. Notification should be sent to:

Internal Revenue Service
Centralized Insolvency Operation
P. O. Box 7346
Philadelphia, PA 19101-7346

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IRS notices are sent to the last known address. This address is determined by the most recently filed tax return, Form 8822, Change of Address, or change of address information obtained from the United States Postal Service. As an official National Change of Address licensee of the USPS, the IRS receives weekly updates of change of address information.

Bankruptcy does not prohibit issuance of all IRS notices, and not all IRS notices violate the automatic stay. Some notices, for example inquiries concerning unfiled returns, will continue to be sent to the debtor's last known address.

For individual debtors, the last known address should always remain the debtor's address. Returns should not be filed "in care of" the trustee. Doing so will change the debtor's address to that of the trustee and all IRS correspondence relating to that taxpayer will be sent to the trustee.

In cases not involving an individual debtor, the debtor's IRS address of record will be changed to the trustee's address if the trustee:

- files a debtor's tax return in care of the trustee at the trustee's address, or
- files a change of address for the debtor with the USPS, or
- files a Form 8822, Change of Address, with the IRS.

Any of the above will result in all future IRS correspondence being sent to the trustee.

Treas. Reg. §301.6212-2 and Rev. Proc. 2010-16, provide guidance on the procedures for making a change of address and explain the requirements for giving the IRS "clear and concise notification" of a change of address.

IRS notices concerning taxes incurred by bankruptcy estates of individuals in chapter 7 and 11 cases, which file separate Form 1041 returns, are properly sent to the bankruptcy trustee. Notices will continue to be sent until the liability is satisfied or the statute of limitations for collection expires.

Certain penalties may apply to returns filed by the trustee for taxes owed by the bankruptcy estate. The penalties may be waived if the Bankruptcy Court finds there are insufficient funds to pay administrative expenses. Contact the Centralized Insolvency Operation at the phone number below if you believe any of the penalties should be waived.

If you have questions regarding a case where IRS is listed as a creditor, contact the Centralized Insolvency Operation. Be prepared to provide the debtor's bankruptcy case number or taxpayer identification number. The IRS may only disclose the information permitted by I.R.C. section 6103.

Call (800) 973-0424 to reach the Centralized Insolvency Operation. Hours are 7 a.m. to 10 p.m. eastern time. ■

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Bankruptcy Cases

Professor Baxter Dunaway

CLASS ACTIONS

Supreme Court

Have the plaintiffs bridged the "conceptual gap" between an individual's claim of injury and the existence of a class of persons who have suffered the same injury in order for a class action to be certified?

The Supreme Court's decision in *Wal-Mart Stores, Inc. v. Dukes*, --- S.Ct. ----, 2011 WL 2437013, 11 Cal. Daily Op. Serv. 7485 (U.S. Jun 20, 2011) considered whether plaintiffs had bridged the "conceptual gap" between an individual's claim of injury and the existence of a class of persons who have suffered the same injury. 2011 WL 2437013, at * 8. The Court held that the gap could be bridged with "significant proof that [defendant] operated under a general policy of discrimination." *Id*. (internal quotation marks omitted). The Court found that such proof was "entirely absent" and emphasized that plaintiffs did not allege "any express corporate policy" of discrimination, *Id*. at *4, and that the challenged pay and promotion decisions were "generally committed to local managers' broad discretion, which [was] exercised in a largely subjective manner." *Id*. at *3.

Syllabus

Respondents, current or former employees of petitioner Wal–Mart, sought judgment against the company for injunctive and declaratory relief, punitive damages, and backpay, on behalf of themselves and a nationwide class of some 1.5 million female employees, because of Wal–Mart's alleged discrimination against women in violation of Title VII of the Civil Rights Act of 1964. They claim that local managers exercise their discretion over pay and promotions disproportionately in favor of men, which has an unlawful disparate impact on female employees; and that Wal–Mart's refusal to cabin its managers' authority amounts to disparate treatment. The District Court certified the class, finding that respondents satisfied Federal Rule of Civil Procedure 23(a), and Rule 23(b)(2)'s requirement of showing that "the party opposing the class has acted or refused to act on grounds that apply generally to the class, so that final injunctive relief or corresponding declaratory relief is appropriate respecting the class as a whole." The Ninth Circuit substantially affirmed, concluding, inter alia, that respondents met Rule 23(a)(2)'s commonality requirement and that their backpay claims could be certified as part of a(b)(2) class because those claims did not predominate over the declaratory and injunctive relief requests. It also ruled that the class action could be manageably tried without depriving Wal–Mart of its right to present its statutory defenses if the District Court selected a random set of claims for valuation and then extrapolated the validity and value of the untested claims from the sample set. *Held*:1. The certification of the plaintiff class was not consistent with Rule 23(a). Pp. ___-

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___.(a) Rule 23(a)(2) requires a party seeking class certification to prove that the class has common "questions of law or fact." Their claims must depend upon a common contention of such a nature that it is capable of classwide resolution—which means that determination of its truth or falsity will resolve an issue that is central to the validity of each one of the claims in one stroke. Here, proof of commonality necessarily overlaps with respondents' merits contention that Wal–Mart engages in a pattern or practice of discrimination. The crux of a Title VII inquiry is "the reason for a particular employment decision," *Cooper v. Federal Reserve Bank of Richmond*, 467 U.S. 867, 876, 104 S.Ct. 2794, 81 L.Ed.2d 718, and respondents wish to sue for millions of employment decisions at once. Without some glue holding together the alleged reasons for those decisions, it will be impossible to say that examination of all the class members' claims will produce a common answer to the crucial discrimination question. Pp. ___-___.(b) *General Telephone Co. of Southwest v. Falcon*, 457 U.S. 147, 102 S.Ct. 2364, 72 L.Ed.2d 740, describes the proper approach to commonality. On the facts of this case, the conceptual gap between an individual's discrimination claim and "the existence of a class of persons who have suffered the same injury," *Id*., at 157–158, must be bridged by "[s]ignificant proof that an employer operated under a general policy of discrimination," *Id*., at 159, n. 15. Such proof is absent here. Wal–Mart's announced policy forbids sex discrimination, and the company has penalties for denials of equal opportunity. Respondents' only evidence of a general discrimination policy was a sociologist's analysis asserting that Wal–Mart's corporate culture made it vulnerable to gender bias. But because he could not estimate what percent of Wal–Mart employment decisions might be determined by stereotypical thinking, his testimony was worlds away from "significant proof" that Wal–Mart "operated under a general policy of discrimination." Pp. ___-___.(c) The only corporate policy that the plaintiffs' evidence convincingly establishes is Wal–Mart's "policy" of giving local supervisors discretion over employment matters. While such a policy could be the basis of a Title VII disparate-impact claim, recognizing that a claim "can" exist does not mean that every employee in a company with that policy has a common claim. In a company of Wal–Mart's size and geographical scope, it is unlikely that all managers would exercise their discretion in a common way without some common direction. Respondents' attempt to show such direction by means of statistical and anecdotal evidence falls well short. Pp. ___-___. 2. Respondents' backpay claims were improperly certified under Rule 23(b)(2). Pp. ___-___.(a) Claims for monetary relief may not be certified under Rule 23(b)(2), at least where the monetary relief is not incidental to the requested injunctive or declaratory relief. It is unnecessary to decide whether monetary claims can ever be certified under the Rule because, at a minimum, claims for individualized relief, like backpay, are excluded. Rule 23(b)(2) applies only when a single, indivisible remedy would provide relief to each class member. The Rule's history and structure indicate that individualized monetary claims belong instead in Rule 23(b)(3), with its procedural protections of predominance, superiority, mandatory notice, and the right to opt out. Pp. ___-___.(b) Respondents nonetheless argue that their backpay claims were appropriately certified under Rule 23(b)(2) because those claims do not "predominate" over their injunctive and declaratory relief requests. That interpretation has no basis in the Rule's text and does obvious violence to the Rule's structural features. The mere "predominance" of a proper (b)(2) injunctive claim does nothing to justify eliminating Rule 23(b)(3)'s procedural protections, and creates incentives for class representatives to place at risk potentially valid monetary relief claims. Moreover, a district court would have to reevaluate the roster of class members continuously to excise those who leave their employment and become ineligible for classwide injunctive or declaratory relief. By contrast, in a properly certified (b)(3) class action for backpay, it would be irrelevant whether the plaintiffs are still employed at Wal–Mart. It follows that backpay claims should not be certified under Rule 23(b)(2). Pp. ___-___.(c) It is unnecessary to decide whether there are any forms of "incidental" monetary relief that are consistent with the above interpretation of Rule 23(b)(2) and the Due Process Clause because respondents' backpay claims are not incidental to their requested injunction. Wal–Mart is entitled to individualized determinations of each employee's eligibility for backpay. Once a plaintiff establishes a pattern or practice of discrimination, a district court must usually conduct "additional proceedings ... to determine the scope of individual relief." *Teamsters v. United States*, 431 U.S. 324, 361, 97 S.Ct. 1843, 52 L.Ed.2d 396. The company can then raise individual affirmative defenses and demonstrate that its action was lawful. *Id*., at 362. The Ninth Circuit erred in trying to replace such proceedings with Trial by Formula. Because Rule 23 cannot be interpreted to "abridge, enlarge or modify any substantive right," 28 U.S.C. § 2072(b), a class cannot be certified on the premise that Wal–Mart will not be entitled to litigate its statutory defenses to individual claims. Pp. ___-___. 603 F.3d 571, reversed. SCALIA, J., delivered the opinion of the Court, in which ROBERTS, C.J., and KENNEDY, THOMAS, and ALITO, JJ., joined, and in which GINSBURG, BREYER, SOTOMAYOR, and KAGAN, JJ., joined as to Parts I and III. Ginsburg, J., filed an opinion concurring in part and dissenting in part, in which BREYER, SOTOMAYOR, and KAGAN, JJ., joined.

Research references: Dunaway, *The Law of Distressed Real Estate*, Ch 61 Class Actions in Federal Courts (Thomson/West 2011, and Westlaw database LAWDRE).

BANKRUPTCY

Supreme Court

Do bankruptcy judges have the constitutional right to reach outside of bankruptcy cases into a probate case?

Issue:

On June 23, 2011, the Supreme Court ruled 5-4 against the estate of Anna Nicole Smith, saying that a bankruptcy judge's decision giving millions to Smith from the estate of oil tycoon J. Howard Marshall was decided incorrectly because those judges do not have the constitutional right to reach outside of bankruptcy cases into a probate case. *Stern v. Marshall*, ___ S.Ct. ___, 2011 WL 2472792 (U.S. Jun 23, 2011) (NO. 10-179).

Syllabus

*1 Article III, § 1, of the Constitution mandates that "[t]he judicial Power of the United States, shall be vested in one supreme Court, and in such inferior Courts as the Congress may from time to

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time ordain and establish," and provides that the judges of those constitutional courts "shall hold their Offices during good Behaviour" and "receive for their Services[ ] a Compensation[ ] [that] shall not be diminished" during their tenure. The questions presented in this case are whether a bankruptcy court judge who did not enjoy such tenure and salary protections had the authority under 28 U.S.C. § 157 and Article III to enter final judgment on a counterclaim filed by Vickie Lynn Marshall (whose estate is the petitioner) against Pierce Marshall (whose estate is the respondent) in Vickie's bankruptcy proceedings.

Vickie married J. Howard Marshall II, Pierce's father, approximately a year before his death. Shortly before J. Howard died, Vickie filed a suit against Pierce in Texas state court, asserting that J. Howard meant to provide for Vickie through a trust, and Pierce tortiously interfered with that gift. After J. Howard died, Vickie filed for bankruptcy in federal court. Pierce filed a proof of claim in that proceeding, asserting that he should be able to recover damages from Vickie's bankruptcy estate because Vickie had defamed him by inducing her lawyers to tell the press that he had engaged in fraud in controlling his father's assets. Vickie responded by filing a counterclaim for tortious interference with the gift she expected from J. Howard.

The Bankruptcy Court granted Vickie summary judgment on the defamation claim and eventually awarded her hundreds of millions of dollars in damages on her counterclaim. Pierce objected that the Bankruptcy Court lacked jurisdiction to enter a final judgment on that counterclaim because it was not a "core proceeding" as defined by 28 U.S.C. § 157(b)(2)(C). As set forth in § 157(a), Congress has divided bankruptcy proceedings into three categories: those that "aris[e] under title 11"; those that "aris[e] in" a Title 11 case; and those that are "related to a case under title 11." District courts may refer all such proceedings to the bankruptcy judges of their district, and bankruptcy courts may enter final judgments in "all core proceedings arising under title 11, or arising in a case under title 11." §§ 157(a), (b)(1). In non-core proceedings, by contrast, a bankruptcy judge may only "submit proposed findings of fact and conclusions of law to the district court." § 157(c)(1). Section 157(b)(2) lists 16 categories of core proceedings, including "counterclaims by the estate against persons filing claims against the estate." § 157(b)(2)(C).

The Bankruptcy Court concluded that Vickie's counterclaim was a core proceeding. The District Court reversed, reading this Court's precedent in *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50, 102 S.Ct. 2858, 73 L.Ed.2d 598, to "suggest[ ] that it would be unconstitutional to hold that any and all counterclaims are core." The court held that Vickie's counterclaim was not core because it was only somewhat related to Pierce's claim, and it accordingly treated the Bankruptcy Court's judgment as proposed, not final. Although the Texas state court had by that time conducted a jury trial on the merits of the parties' dispute and entered a judgment in Pierce's favor, the District Court went on to decide the matter itself, in Vickie's favor. The Court of Appeals ultimately reversed. It held that the Bankruptcy Court lacked authority to enter final judgment on Vickie's counterclaim because the claim was not "so closely related to [Pierce's] proof of claim that the resolution of the counterclaim is necessary to resolve the allowance or disallowance of the claim itself." Because that holding made the Texas probate court's judgment the earliest final judgment on matters relevant to the case, the Court of Appeals held that the District Court should have given the state judgment preclusive effect.

Held: Although the Bankruptcy Court had the statutory authority to enter judgment on Vickie's counterclaim, it lacked the constitutional authority to do so. Pp. ___-___.

*2 1. Section 157(b) authorized the Bankruptcy Court to enter final judgment on Vickie's counterclaim. Pp. ___-___.

(a) The Bankruptcy Court had the statutory authority to enter final judgment on Vickie's counterclaim as a core proceeding under § 157(b)(2)(C). Pierce argues that § 157(b) authorizes bankruptcy courts to enter final judgments only in those proceedings that are both core and either arise in a Title 11 case or arise under Title 11 itself. But that reading necessarily assumes that there is a category of core proceedings that do not arise in a bankruptcy case or under bankruptcy law, and the structure of § 157 makes clear that no such category exists. Pp. ___-___.

(b) In the alternative, Pierce argues that the Bankruptcy Court lacked jurisdiction to resolve Vickie's counterclaim because his defamation claim is a "personal injury tort" that the Bankruptcy Court lacked jurisdiction to hear under § 157(b)(5). The Court agrees with Vickie that § 157(b)(5) is not jurisdictional, and Pierce consented to the Bankruptcy Court's resolution of the defamation claim. The Court is not inclined to interpret statutes as creating a jurisdictional bar when they are not framed as such. See generally *Henderson v. Shinseki*, 562 U.S. ——, 131 S.Ct. 1197, 179 L.Ed.2d 159; *Arbaugh v. Y & H Corp.*, 546 U.S. 500, 126 S.Ct. 1235, 163 L.Ed.2d 1097. Section 157(b)(5) does not have the hallmarks of a jurisdictional decree, and the statutory context belies Pierce's claim that it is jurisdictional. Pierce consented to the Bankruptcy Court's resolution of the defamation claim by repeatedly advising that court that he was happy to litigate his claim there. Pp. ___-___.

2. Although § 157 allowed the Bankruptcy Court to enter final judgment on Vickie's counterclaim, Article III of the Constitution did not. Pp. ___-___.

(a) Article III is "an inseparable element of the constitutional system of checks and balances" that "both defines the power and protects the independence of the Judicial Branch." *Northern Pipeline*, 458 U.S., at 58, 102 S.Ct. 2858 (plurality opinion). Article III protects liberty not only through its role in implementing the separation of powers, but also by specifying the defining characteristics of Article III judges to protect the integrity of judicial decisionmaking.

This is not the first time the Court has faced an Article III challenge to a bankruptcy court's resolution of a debtor's suit. In Northern Pipeline, the Court considered whether bankruptcy judges serving under the Bankruptcy Act of 1978—who also lacked the tenure and salary guarantees of Article III—could "constitutionally be vested with jurisdiction to decide [a] state-law contract claim" against an entity that was not otherwise part of the bankruptcy proceedings. *Id.*, at 53, 87, n. 40, 102 S.Ct. 2858

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(plurality opinion). The plurality in *Northern Pipeline* recognized that there was a category of cases involving "public rights" that Congress could constitutionally assign to "legislative" courts for resolution. A full majority of the Court, while not agreeing on the scope of that exception, concluded that the doctrine did not encompass adjudication of the state law claim at issue in that case, and rejected the debtor's argument that the Bankruptcy Court's exercise of jurisdiction was constitutional because the bankruptcy judge was acting merely as an adjunct of the district court or court of appeals. *Id*., at 69–72, 102 S.Ct. 2858; see *Id*., at 90–91, 102 S.Ct. 2858 (Rehnquist, J., concurring in judgment). After the decision in *Northern Pipeline*, Congress revised the statutes governing bankruptcy jurisdiction and bankruptcy judges. With respect to the "core" proceedings listed in § 157(b)(2), however, the bankruptcy courts under the Bankruptcy Amendments and Federal Judgeship Act of 1984 exercise the same powers they wielded under the 1978 Act. The authority exercised by the newly constituted courts over a counterclaim such as Vickie's exceeds the bounds of Article III. Pp. ___-___.

(b) Vickie's counterclaim does not fall within the public rights exception, however defined. The Court has long recognized that, in general, Congress may not "withdraw from judicial cognizance any matter which, from its nature, is the subject of a suit at the common law, or in equity, or admiralty." *Murray's Lessee v. Hoboken Land & Improvement Co.*, 59 U.S. 272, 18 How. 272, 284, 15 L.Ed. 372. The Court has also recognized that "[a]t the same time there are matters, involving public rights, ... which are susceptible of judicial determination, but which congress may or may not bring within the cognizance of the courts of the United States, as it may deem proper." *Ibid*. Several previous decisions have contrasted cases within the reach of the public rights exception—those arising "between the Government and persons subject to its authority in connection with the performance of the constitutional functions of the executive or legislative departments"—and those that are instead matters "of private right, that is, of the liability of one individual to another under the law as defined." *Crowell v. Benson*, 285 U.S. 22, 50, 51, 52 S.Ct. 285, 76 L.Ed. 598.

*3 Shortly after *Northern Pipeline*, the Court rejected the limitation of the public rights exception to actions involving the Government as a party. The Court has continued, however, to limit the exception to cases in which the claim at issue derives from a federal regulatory scheme, or in which resolution of the claim by an expert Government agency is deemed essential to a limited regulatory objective within the agency's authority. In other words, it is still the case that what makes a right "public" rather than private is that the right is integrally related to particular Federal Government action. See *United States v. Jicarilla Apache Nation*, 564 U.S. ___, ___-___, 131 S.Ct. 2313, ___ L.Ed.2d ___, 2011 WL 2297786, *8–9 (2011); *Thomas v. Union Carbide Agricultural Products Co.*, 473 U.S. 568, 584, 105 S.Ct. 3325, 87 L.Ed.2d 409; *Commodity Futures Trading Commission v. Schor*, 478 U.S. 833, 844, 856, 106 S.Ct. 3245, 92 L.Ed.2d 675.

In *Granfinanciera, S.A. v. Nordberg*, 492 U.S. 33, 109 S.Ct. 2782, 106 L.Ed.2d 26, the most recent case considering the public rights exception, the Court rejected a bankruptcy trustee's argument that a fraudulent conveyance action filed on behalf of a bankruptcy estate against a noncreditor in a bankruptcy proceeding fell within the exception. Vickie's counterclaim is similar. It is not a matter that can be pursued only by grace of the other branches, as in *Murray's Lessee*, 18 How., at 284; it does not flow from a federal statutory scheme, as in *Thomas*, 473 U.S., at 584–585, 105 S.Ct. 3325; and it is not "completely dependent upon" adjudication of a claim created by federal law, as in *Schor*, 478 U.S., at 856, 106 S.Ct. 3245. This case involves the most prototypical exercise of judicial power: the entry of a final, binding judgment by a court with broad substantive jurisdiction, on a common law cause of action, when the action neither derives from nor depends upon any agency regulatory regime. If such an exercise of judicial power may nonetheless be taken from the Article III Judiciary simply by deeming it part of some amorphous "public right," then Article III would be transformed from the guardian of individual liberty and separation of powers the Court has long recognized into mere wishful thinking. Pp. ___-___.

(c) The fact that Pierce filed a proof of claim in the bankruptcy proceedings did not give the Bankruptcy Court the authority to adjudicate Vickie's counterclaim. Initially, Pierce's defamation claim does not affect the nature of Vickie's tortious interference counterclaim as one at common law that simply attempts to augment the bankruptcy estate—the type of claim that, under *Northern Pipeline* and *Granfinanciera*, must be decided by an Article III court. The cases on which Vickie relies, *Katchen v. Landy*, 382 U.S. 323, 86 S.Ct. 467, 15 L.Ed.2d 391, and *Langenkamp v. Culp*, 498 U.S. 42, 111 S.Ct. 330, 112 L.Ed.2d 343 (*per curiam*), are inapposite. *Katchen* permitted a bankruptcy referee to exercise jurisdiction over a trustee's voidable preference claim against a creditor only where there was no question that the referee was required to decide whether there had been a voidable preference in determining whether and to what extent to allow the creditor's claim. The *Katchen* Court "intimate[d] no opinion concerning whether" the bankruptcy referee would have had "summary jurisdiction to adjudicate a demand by the [bankruptcy] trustee for affirmative relief, all of the substantial factual and legal bases for which ha[d] not been disposed of in passing on objections to the [creditor's proof of] claim." 382 U.S., at 333, n. 9, 86 S.Ct. 467. The *per curiam* opinion in *Langenkamp* is to the same effect. In this case, by contrast, the Bankruptcy Court—in order to resolve Vickie's counterclaim—was required to and did make several factual and legal determinations that were not "disposed of in passing on objections" to Pierce's proof of claim. In both *Katchen* and *Langenkamp*, moreover, the trustee bringing the preference action was asserting a right of recovery created by federal bankruptcy law. Vickie's claim is instead a state tort action that exists without regard to any bankruptcy proceeding. Pp. ___-___.

*4 (d) The bankruptcy courts under the 1984 Act are not "adjuncts" of the district courts. The new bankruptcy courts, like the courts considered in *Northern Pipeline*, do not "ma[k]e only specialized, narrowly confined factual determinations regarding a particularized area of law" or engage in "statutorily channeled factfinding functions." 458 U.S., at 85, 102 S.Ct. 2858 (plurality opinion). Whereas the adjunct agency in *Crowell v. Benson* "possessed only a limited power to issue compensation orders ... [that] could be enforced only by order of the district court," *ibid*., a bankruptcy court resolving a counterclaim under § 157(b)(2)(C) has the power to enter "appropriate orders and judgments"—

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including final judgments—subject to review only if a party chooses to appeal, see §§ 157(b)(1), 158(a)-(b). Such a court is an adjunct of no one. Pp. ___-___.

(e) Finally, Vickie and her *amici* predict that restrictions on a bankruptcy court's ability to hear and finally resolve compulsory counterclaims will create significant delays and impose additional costs on the bankruptcy process. It goes without saying that "the fact that a given law or procedure is efficient, convenient, and useful in facilitating functions of government, standing alone, will not save it if it is contrary to the Constitution." *INS v. Chadha*, 462 U.S. 919, 944, 103 S.Ct. 2764, 77 L.Ed.2d 317. In addition, the Court is not convinced that the practical consequences of such limitations are as significant as Vickie suggests. The framework Congress adopted in the 1984 Act already contemplates that certain state law matters in bankruptcy cases will be resolved by state courts and district courts, see §§ 157(c), 1334(c), and the Court does not think the removal of counterclaims such as Vickie's from core bankruptcy jurisdiction meaningfully changes the division of labor in the statute. Pp. ___-___.

*5 600 F.3d 1037, affirmed.

ROBERTS, C.J., delivered the opinion of the Court, in which SCALIA, KENNEDY, THOMAS, and ALITO, JJ., joined. SCALIA, J., filed a concurring opinion. BREYER, J., filed a dissenting opinion, in which GINSBURG, SOTOMAYOR, and KAGAN, JJ., joined.

Eighth Circuit

Does a losing bidder for Chapter 11 debtor's assets have standing to pursue an action for damages against the successful bidder?

Unsuccessful bidder for Chapter 11 debtor's assets brought adversary proceeding against entities that formed successful bidder and others, asserting claims for civil conspiracy and tortious interference with business expectancy. Eighth Circuit holds that a losing bidder does not have standing under traditional analysis or under fraud on the court theory to pursue an action for damages against the successful bidder. *In re Farmland Industries, Inc.*, 639 F.3d 402 (8th Cir. Apr 04, 2011) (NO. 09-3049).

Before reaching the merits of a case, federal courts must ensure that Article III standing exists. *Gray v. City of Valley Park*, Mo., 567 F.3d 976, 982–83 (8th Cir.2009); see also *In re Res. Tech. Corp.*, 624 F.3d 376, 382 (7th Cir.2010) ("Article III's standing requirements apply to proceedings in bankruptcy courts just as they do to proceedings in district courts."). The "irreducible constitutional minimum of standing requires a showing of injury in fact to the plaintiff that is fairly traceable to the challenged action of the defendant." *Braden v. Wal–Mart Stores, Inc.*, 588 F.3d 585, 591 (8th Cir.2009) (internal quotations omitted).

Unsuccessful bidder for Chapter 11 debtor's assets did not suffer injury traceable to actions of group of entities that formed successful bidder, and thus unsuccessful bidder lacked standing in adversary proceeding asserting claims for civil conspiracy and tortious interference with business expectancy. Unsuccessful bidder could only have purchased debtor's assets through bidding process approved by bankruptcy court, bankruptcy court found that unsuccessful bidder's bid did not satisfy auction and sale bidding procedure requirements, and unsuccessful bidder did not allege any facts suggesting successful bidder was responsible for deficiencies in its bid.

Fifth Circuit

Does a president and CEO of corporate general partner of limited partnership owe a fiduciary duty to partnership and has committed defalcation under § 523(a)(4) by making loans from partnership to president?

Chapter 7 debtor appealed from an order of the United States District Court, affirming a bankruptcy court's ruling that certain of his debts were nondischargeable. The Fifth Circuit agreed with the bankruptcy court's holding that loans debtor obtained from a limited partnership that the debtor managed were nondischargeable under § 523(a)(4). An officer of a corporate general partner who is entrusted with the management of a limited partnership and who exercises control over the limited partnership owes a fiduciary duty to the partnership for purposes of nondischargeability under § 523(a)(4). The debtor's failure to record deeds of trust on the debtor's property securing his obligation to repay loans from the limited partnership constituted defalcation for purposes of nondischargeability under § 523(a)(4). *FNFS, Ltd. v. Harwood (In re Harwood)*, 637 F.3d 615 (5th Cir. 2011).

Research References: Norton Bankr. L. & Prac. 3d §§ 57:21 to 57:29

Third Circuit

Do liability insurers have standing to challenge Chapter 11 plan confirmation?

A split-divided Third Circuit Court of Appeals holds that even if the Chapter 11 debtors' liability insurers' ultimate liability was contingent, the insurers were "parties in interest," and thus had standing to challenge the confirmation of a plan of reorganization calling for them to fund a settlement trust created to satisfy a debtor's liability on silica-related claims against it. *In re Global Indus. Technologies, Inc.*, ___ F.3d ___, 2011 WL 1662792, Bankr. L. Rep. P 81,998 (3rd Cir.(Pa.) May 04, 2011) (NO. 08-3650). ■

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