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Liquidation Basis of Accounting: FASB Proposes Guidance on Topic for Which Little Has Been Written

James M. Lukenda, CIRA
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On July 2, 2012, the Financial Accounting Standards Board ("FASB") issued an exposure draft of a proposed Accounting Standards Update to Accounting Standards Codification ("ASC") Topic 205, Presentation of Financial Statements, titled *The Liquidation Basis of Accounting* (the "Exposure Draft"). The AIRA submitted a comment letter to the FASB on October 1, 2012; see Exhibit on pp. 6-8.

Prior to the adoption of the Accounting Standards Codification, U.S. Generally Accepted Accounting Principles ("GAAP") provided very little guidance on what constitutes the "liquidation basis" of accounting or how that basis of accounting should be applied. Conducting a literature search on the topic yields a number of references to liquidation basis of accounting, but little actual guidance on implementation. Perhaps the most detailed guidance is contained in generally accepted auditing standards ("GAAS") which provides guidance on an auditor's ability to issue an unqualified opinion on liquidation basis financial statements. The GAAS literature[1] provides that a liquidation basis of accounting may be considered GAAP for entities in liquidation or for which liquidation appears imminent. GAAS allow an auditor to issue an unqualified opinion on such financial statements provided the liquidation basis of accounting has been properly applied and adequate disclosures have been made in the financial statements. The example opinion in the literature refers to a statement of net assets in liquidation and related statement of changes in net assets as the two financial statements upon which the opinion would be rendered.

In 1984 the AICPA released its Financial Report Survey, *Illustrations of Accounting for Enterprises in Unusual Circumstances and Reporting on Them by Independent Accountants* (the "Survey"), a survey of troubled enterprises, reorganized enterprises, and liquidating enterprises. In the scope and purpose of the Survey, the authors provide a short review of the then existing literature related to troubled, reorganized, and liquidating enterprises. This included Accounting Principles Board Opinion 30, "Reporting the Results of Operations", Financial Accounting Standards Statement No. 15, "Accounting by Debtors and Creditors for Troubled Debt Restructurings", the quasi-reorganization section of Accounting Research Bulletin ("ARB") No. 43, and ARB No. 46, "Discontinuance of Dating Earned Surplus". The authors also cited Statement on Auditing Standards No. 34 ("SAS No. 34"), "The Auditor's Considerations When a Question Arises About an Entity's Continued Existence", reproducing SAS No. 34 as an appendix to the Survey. Drawing from the AICPA's National Automated Accounting Research System, the Survey included the financial statements and auditors' reports for three entities in liquidation.

Since the Survey, the AICPA issued Statement of Position 90-7, "Financial Reporting by Entities in Reorganization Under the Bankruptcy Code", now codified as FASB ASC 852, *Reorganizations*, addressing reporting during and upon emergence from Chapter 11 bankruptcy, but not addressing accounting for entities in liquidation.

The adoption of the Accounting Standards Codification in 2009 added no other significant authoritative guidance to address what constitutes liquidation basis accounting and the circumstances when liquidation basis accounting would be appropriately applied. International Financial Reporting Standards ("IFRS") are similar to existing GAAP in that IFRS currently does not provide explicit guidance on when or how to apply liquidation basis accounting.

In 2007 the FASB added a project to its agenda to address both going concern issues and the liquidation basis of accounting. For a time, the going concern aspect of the project was more immediate as the FASB sought to incorporate the AICPA's Codification of Statements on Auditing Standards AU Section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, into GAAP. The FASB issued an exposure draft in 2008 on going concern considerations. As a result

***Liquidation Basis** continues on p. 4*

1 Currently codified as AU Section 9508 section .33-.38

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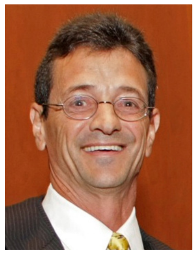


A Letter from the President

Anthony V. Sasso, CIRA
Deloitte CRG

Hello again! The summer has passed us by and winter is just around the corner. I have two more quality events to bring to your attention as you plan out your continuing education calendars for the upcoming year.

VALCON 2013
We all hate the winter blues as we get into the month of February. How about some recreation in Las Vegas while getting a head start on your CPE or CLE credits for 2013? This year, the AIRA is again co-hosting this conference with The University of Texas and the American Bankruptcy Institute. Valcon is focused on valuation for the distressed industry. This year's conference, titled "Contested Valuation Issues in Bankruptcy", will take place this coming February 20th through February 22nd at the Four Seasons Hotel.

Since I couldn't say it any better, I'll quote from the abiworld.org website: "VALCON 2013 is a unique opportunity to meet some of the leading professionals and dealmakers in the distressed debt, restructuring and valuation business. If you are a dealmaker, fund investor, or financial or legal advisor, you'll want to join us! Earn up to 15.25/18 hours of CLE/CPE credit, including 1 hour of Ethics!" Check in at abiworld.com to register and to obtain more details as they become available.

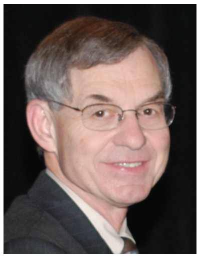
AIRA's 29th Annual Bankruptcy and Restructuring Conference
Planning for the 29th Annual Conference in Chicago is underway! This marquee event will take place next June 5th through June 8th at the Westin Chicago River North. Always a great place to visit, the Windy City is waiting! The Planning Committee has the planning process well underway. This year's co-chairs include Keith Shapiro, Chairman of the Chicago Office of Greenberg Traurig; Charlie Braley, a Managing Director with Alix Partners; and Monty Kehl, a Senior Managing Director with Mesirow Financial Consulting. While the agenda is not yet finalized, you can count on a great educational and social experience, with high profile key note speakers, the latest important happenings in our profession, and social events that only the great city of Chicago can offer. So mark your calendars. We hope to see you there!

In addition to the above two events, one last reminder - AIRA 11th Annual Advanced POR Conference
This year's Advanced POR Conference takes place on November 19th at the Union League Club, 38 East 37th Street, New York. As I mentioned in my last letter, join us for an interesting day of discussion of important events impacting our profession that have occurred over the past year, pick up 8 hours of CPE credit and also join the post conference cocktail reception, where we will honor Judge Mary Walrath for her distinguished service to the bench over the years.

That's it for now. I hope to see you at an AIRA event soon!

Tony Sasso

Anthony Sasso



Executive Director's Column

Grant Newton, CIRA
AIRA Executive Director

TIME TO REVISIT SOP 90-7?

Recently the FASB issued an exposure draft dealing with liquidation accounting. In response AIRA's Board of Directors prepared a comment letter (see Exhibit on pp. 6-8) including recommendations for the FASB to consider in its deliberation of liquidation accounting. James M. Lukenda, CIRA, former president of AIRA and Board member, has written an article for this issue of *AIRA Journal* (see p. 1) examining the Exposure Draft and AIRA's response. With the FASB's interest in liquidation accounting, it may well be time for AIRA to again request the FASB consider modifications to ASC 852 (formerly SOP 90-7) dealing with accounting principles for companies in and emerging from chapter 11.

Seven years ago, in 2005, AIRA's Board of Directors sent the FASB recommendations for changes to SOP 90-7 (ASC 852); however, the FASB has not yet made any modifications. A committee is being established to review the previous recommendations and prepare revised recommendations for the FASB to consider. Anyone that would like to serve on the committee should let me know.

A summary of some of the changes recommended in 2005 follows:

1. Expansion to nonjudicial proceedings of guidelines similar to those followed in chapter 11.
2. Modification of the discussion of reorganization value to explain how it differs from enterprise value, because reorganization value encompasses such a central role in developing a Plan of Reorganization that complies with conditions necessary to receive confirmation under the Code.
3. Because there is significant diversity in classification of pre-petition liabilities on the balance sheet, recommendations were made for the clarifying claims treatment in order to improve consistency in financial reporting.
4. Provision of an explanation as to how recharacterization (where the nature of the obligation has changed by consent or court order) should be disclosed in bankruptcy situations.
5. The existing standard requires adjustment of the carrying amount of the debt to the amount of the allowed claim (through adjustment of deferred issuance costs, discounts and premiums) only "when the debt has become an allowed claim" and only for debts that are subject to compromise. It was recommended that the debt, even if not subject to compromise, still be treated as a claim where the allowed amount will be determined pursuant to the plan and will receive a recovery—whether in cash, new debt or otherwise—pursuant to the plan, and should therefore be adjusted to the amount of the allowed claim.
6. Clarification as to whether reorganization items should be included as a component of operating income or presented below operating income (but still as part of income (loss) from continuing operations). Practice has varied with some Debtors including reorganization items as part of operating income and some not. Consistent with Appendix A of the original SOP, the Committee believes the intent of the SOP was to segregate reorganization items from operating income and therefore only require them tobe included in income (loss) from continuing operations.
7. It should be required that, absent material conditions, fresh-start reporting be adopted as of the confirmation date. It is believed that the effective date is a more appropriate date to record the effects of the Plan and adopt fresh-start reporting, since it is on this date (similar to a closing date of an acquisition) that the restructuring (cancellation and issuance of old and new equity and debt instruments) legally occurs. This allows for the financial reporting cut-off to be consistent with the legal (and tax) event. It is also more efficient for accounting purposes to reduce the amount of estimation that may be necessary to record events.
8. In evaluating the so called "change in control" test for determining whether the reorganized company qualifies for Fresh Start accounting, language is recommended to clarify that only voting shares issued on account of old equity interests should be considered. It is recommended that shares issued to creditors as a result of a claim or to investors as a result of a new value contribution should not be considered as shares issued to holders of existing shares even though such creditors or investors may have also been equity holders of the debtor. The same entities may simultaneously be both owners and employees, owners and creditors, owners and customers, creditors and customers, or some other combination.
9. Excluding equity issued on account of new value contributions by existing shareholders from the change in control test has a similar basis. In conjunction with the negotiated chapter 11 process, and as required by the Supreme Court in 203 North LaSalle, the new value contributed by an existing shareholder to maintain an equity stake in the reorganized company generally represents a fair value purchase of that interest for new consideration. The creditors in a case where the new shares are issued to an investor have sold their control stake in the reorganized company to the investor.

Hurricane Sandy's Impact

A large part of AIRA's membership is located in the Eastern Seaboard and surrounding areas. On October 30, 2012, as this issue of *AIRA Journal* is being completed the phones and emails at AIRA's office have been strangely quiet. Our thoughts and prayers are with our many friends and associates that were in Sandy's path and that are facing tremendous challenges at home and work and in their communities.

of comments on that exposure draft and other deliberations, the FASB subsequently decided to address liquidation basis of accounting as the first phase of a two part project with the second phase addressing management's responsibility for going concern assessments.

The Exposure Draft defines Liquidation as "the process by which an entity converts its assets to cash or other assets and partially or fully settles its obligations with creditors in anticipation of the entity ceasing operations. Any remaining cash or other assets are distributed to the entity's owners. Liquidation may be compulsory or voluntary. Dissolutions via acquisition or merger do not qualify as liquidations."

The Exposure Draft is organized as follows:

Overview and Background – This section establishes that the subtopic, "Liquidation Basis" (the "Subtopic"), provides guidance on when liquidation basis of accounting should be applied, how it should be applied and what disclosures the entity should include in its financial statements. While cautioning that the Subtopic should not be relied on to interpret bankruptcy law, it indicates that the Subtopic addresses accounting and financial statement disclosures for entities that are expected to liquidate under Chapter 7 of the U.S. Bankruptcy Code. Lastly, this section establishes that the Subtopic guidance is incremental to other existing GAAP.

Scope and Scope Exceptions - The Subtopic is applicable to all entities. Public or private, for profit or eleemosynary, if the entity meets the recognition criteria as proposed, the liquidation basis standard would apply.

Recognition – In recognition, the FASB has adopted and expounded upon the concept of imminence. The terminology contained in the Exposure Draft has been used before to describe when liquidation basis accounting is appropriate without a specific definition or description of when liquidation may be imminent. The Exposure Draft establishes that liquidation is imminent when either of the following occurs:

a. A plan for liquidation has been approved by the person or persons with the authority to make such a plan effective and the likelihood is remote that the execution of the plan will be blocked by other parties (for example, those with protective rights).

b. A plan for liquidation is imposed by other forces (for example, involuntary bankruptcy) and the likelihood is remote that the entity will return from liquidation.[2]

The recognition criteria separately address situations where an entity's governing documents specify a plan for liquidation such as with limited life entities. The FASB considered the general recognition criteria problematic for such entities since they could be construed to meet the definition requiring liquidation accounting from the outset. In those situations, liquidation is only deemed imminent when management's decisions no longer further the ongoing operations or those decisions become limited to executing a plan of liquidation that differs from the plan that may be specified in the entity's governing documents. Examples of the latter situation include an earlier or later date for liquidation than contained in the governing documents and disposing of assets in other than an orderly manner.

2 Exposure Draft section 205-30-25-2

Recognition criteria include the requirement that liquidation basis accounting be applied prospectively from the day that management concludes that liquidation is imminent. As proposed, the liquidating entity would report the cumulative effect adjustment required to recognize the change from a going concern basis to the liquidation basis in accounting in the entity's statement of changes in net assets in liquidation. This is inconsistent with the treatment required for entities emerging from Chapter 11 and meeting the requirements of "fresh-start" accounting specified in ASC Section 852-10-45-21, "…the effects of the adjustments on the reported amounts of individual assets and liabilities resulting from the adoption of fresh-start reporting…shall be reflected in the predecessor entity's final statement of operations."[3]

Initial Measurement – As proposed asset and liability values should be reduced/increased to the amount of cash or other consideration management expects to realize or pay carrying out the plan of liquidation. The costs of monetizing the assets and settling the liabilities (I will call these "disposition costs") should be estimated, accrued, and presented in aggregate separately from the measurement of the assets and liabilities. Other expenses and any revenue related to liquidating the entity such as payroll expense, interest income, or interest expense (again, my terminology, the "administrative costs") though the expected completion date of the liquidation must also be estimated, accrued, and separately presented.

Subsequent Measurement – Subsequent to the initial measurement date, financial presentations should reflect the remeasurement of the assets, liabilities, disposition costs, and administrative costs to reflect the actual or estimated change in value since the prior reporting date.

Other Presentation Matters – The minimum required financial statements under the Exposure Draft are a statement of net assets in liquidation and a statement of changes in net assets in liquidation.

Disclosure – The minimum disclosures specific to the liquidation basis of accounting (as noted above, these requirements are incremental to all other applicable GAAP) are:

a. Identification of the statements as being prepared on the liquidation basis of accounting with a description of the circumstances related to the determination that liquidation is imminent;

b. A description of the plan of liquidation with a minimum requirement to describe the manner in which management expects to liquidate the assets and liabilities and an estimate of the liquidation time horizon;

3 In the author's view, recognizing the effects of commencing a plan of liquidation is more similar than not to the recognition of the effects of implementing a plan of reorganization. Both from an economic view point and a practical presentation view, the adjustments transitioning the entity from going concern accounting to liquidation basis accounting should be reflected in the entity's final statement of operations. The decision to adopt a plan of liquidation belongs to the period prior to the commencement of the liquidation. Presenting a statement of changes in net assets available for liquidation that begins with assets and liabilities presented on a going concern basis also appears to be inconsistent with measuring the effects of changes in the net assets available for liquidation.

c. A description of the methods employed to estimate the value of the assets and liabilities including any changes in methods and assumptions between reporting periods, and

d. Disclosure of the categories and amount of revenue and expenses accrued for disposal and administrative costs in the statement of changes in net assets in liquidation.

Implementation Guidance and Illustrations – the Exposure Draft provides three non-comprehensive examples to illustrate how the liquidation basis of accounting should apply to (i) a normal operating entity, (ii) a limited-life entity with unplanned liquidation, and (iii) a limited-life entity that liquidates as planned at inception. What isn't clear in the Exposure Draft before this guidance, but is clear in the last of these examples, is that a limited-life entity that liquidates as planned at inception would not employ the liquidation basis of accounting in carrying out its liquidation because the actual liquidation would be consistent with the plan specified in the governing documents.

Transition and Open Effective Date of Information – Application would be effective as of the beginning of a reporting entity's first annual reporting period after the effective date of the proposed accounting standards update with earlier application permitted. The effective date for the proposed accounting standards update is not specified in the Exposure Draft.

When reviewing the Exposure Draft I found it helpful to look at existing examples of liquidation basis of accounting financial statements. A few of the more recent and comprehensive financial statements I read in conjunction with reading the exposure draft are the following:

Motors Liquidation Company (Old General Motors) – From Motors Liquidation Company GUC Trust Quarterly GUC Trust Reports as of June 30, 2012 – The quarterly report filed with the bankruptcy court and with the Securities and Exchange Commission on Form 8K. This is a comprehensive example of a post Chapter 11 liquidating trust financial statement.

Handleman Company – Annual report on Form 10K for a company in liquidation. The period ending May 1, 2010 statements include both the transition from a going concern as of October 4, 2008, to an entity in liquidation where initially liabilities exceeded assets. The May 1, 2010 statements reflect an improvement in the position of the company to the point where assets exceed liabilities.

Footstar, Inc. – Annual report on Form 10K for a company in liquidation. The December 31, 2011 financial statements are interesting in that Footstar, while in liquidation, acquires an investment in a going concern entity. ■

James M. Lukenda, CIRA, *is Managing Director with Huron Consulting Group. Over the course of his career, Jim has assisted clients of varying size and scope across a wide range of industries. Since focusing his practice in late 1988 on assisting clients with restructuring and bankruptcy matters, Jim has worked on behalf of companies and their directors, lenders, committees of creditors, and other parties-in-interest in capacities ranging from consultant and advisor to chief restructuring officer.*

Exhibit: AIRA Board of Directors Comment Letter on FASB Exposure Draft

October 1, 2012
Technical Director
Financial Accounting Standards Board
401 Merritt 7, PO Box 5116
Norwalk, CT 06856-5116
By e-mail: director@fasb.org

Re: Exposure Draft: Proposed Accounting Standards Update – *The Liquidation Basis of Accounting* (the "Exposure Draft"), File Reference No. 2012-210

The Association of Insolvency and Restructuring Advisors ("AIRA") is a nonprofit professional association whose approximately 4,000 members serve as financial advisors, accountants, crisis managers, business turnaround consultants, lenders, investment bankers, attorneys, trustees, and in other positions involved in the fields of business turnaround, restructuring, bankruptcy, and insolvency. From these positions, our membership has significant experience with matters involving the accounting and reporting requirements of companies in reorganization and liquidation, and in the gray area between the two.

Members of AIRA's technical committee have deliberated the above referenced exposure draft and have the following comments. If you would like additional discussion with AIRA, please contact Grant Newton, Executive Director, AIRA at 541-858-1665, gnewton@aira.org.

AIRA agrees that there is a need for additional guidance as to when an entity should apply liquidation basis accounting and for principles to be applied in measuring assets and liabilities under the liquidation basis of accounting, as well as required disclosures. This guidance should be applicable to both public and non-public entities in liquidation.

Amendments to the Master Glossary

Liquidation – the last section of the definition referring to acquisition or merger is unclear. As worded, the statement implies the perspective of an acquirer not the seller or liquidator. In addition, as discussed below under "Recognition", the practice of liquidating an enterprise while still under court supervision in a Chapter 11 proceeding under the Bankruptcy Code does not lend itself to liquidation basis accounting. We believe that the same factors cited for the treatment of limited life entities apply to debtors in a Chapter 11 proceeding and that the statement should be worded along the following: "Dissolutions that may commence under Chapter 11 of the Bankruptcy Code before the confirmation of a plan or conversion to a case under Chapter 7 do not qualify as liquidations. Dissolutions through a going concern merger and acquisition sale of assets or businesses do not qualify as liquidations."

The definitions of the major statements (Statement of Changes in Net Assets in Liquidation and Statement of Net Assets in Liquidation) refer to "net assets available for distribution to investors and other claimants". This language is at odds with the priority of distribution in most situations and with the language contained in the definition, "Liquidation". Many liquidations to which the proposed standard would apply are carried out though post-bankruptcy trusts. These trusts do not have investors but rather beneficiaries. We suggest the definition incorporate language along the following: "net assets available to creditors, other claimants, and the entity's owners or beneficiaries".

The definition of Statement of Net Assets in Liquidation implies that the statement would not include entities' obligations that existed prior to commencing the plan of liquidation. For example, assume that an entity has assets with a going concern value of $100 and an amount owed to a vendor of $75. The entity enters into a plan of liquidation valuing its assets at $70, estimating the cost to liquidate those assets at $10, and expecting to incur administrative costs in the wind-down of $10. Does the entity report Net Assets in Liquidation of $50 ($70 minus $10, minus $10) that are available to distribute on its obligation to the vendor of $75, or does the entity report Net Assets in Liquidation of $(25)?

Considering the different capital structures/beneficiaries that entities in liquidation could have, depending on whether the liquidation is occurring within a court proceeding (Chapter 7, state court receivership, etc.) or out of court (orderly wind-down, an assignment for the benefit of creditors, liquidating trust, etc.), we believe the Statement of Net Assets in Liquidation should present the estimated liquidation value of an entity's assets offset by the costs to liquidate and the costs to administer the liquidation (the costs described in 205-30-30-2 and 205-30-30-3 of the Exposure Draft).

In order to provide information that parties in interest require to interpret the anticipated results of liquidation either in a separate statement or in footnote disclosure, the following details should be provided in the financial statements:

- In situations where the entity has secured debt, secured obligations should be segregated from unsecured obligations. The assets comprising the security for the debt should be segregated and identified as comprising security for the related debt.
- All other liabilities should be classified according to priority of payment under applicable law or other agreement. If there are differences between the entity's estimate of allowed claims and liabilities to be satisfied from liquidation proceeds and the claims asserted by creditors and other parties in interest, the amount of those differences should be disclosed.
- Items such as preferred stock with preference in liquidation should be stated at the amount of the liquidation preference.
- After the initial measurement period, the disclosures discussed above should be accompanied by an explanation of the changes in the amounts disclosed since the prior reporting period.

Recognition

205-30-25-2 b. references the example of involuntary bankruptcy. This example should be revised along the following: "for example, the entry of either a voluntary or involuntary order under Chapter 7 of the Bankruptcy Code". An involuntary bankruptcy filing by creditors may request an entry of an order under either Chapter 11 (the reorganization section of the Bankruptcy Code) or under the liquidation provisions of Chapter 7 of the Bankruptcy Code. In either case, the debtor has a period to respond to the court to consent to or to seek to amend the order or to seek to have the petition dismissed. Accordingly, it is only after the debtor's response (which may also seek to have the petition under Chapter 7 converted to an order under Chapter 11) and the court's order that the liquidation basis of accounting might be required.

Many large and complex Chapter 11 cases are conducted as what are commonly referred to as "Liquidating Elevens". These are Chapter 11 cases during which the debtor's businesses or other assets are sold through going concern M&A procedures, auction, and sales following procedures under section 363 of the Bankruptcy Code (so called "363 sales"). An example of such a case would be the current Chapter 11 bankruptcy of Nortel Networks Inc. ("NNI") in the District of Delaware. Since 2009 NNI has been liquidating its businesses and assets through 363 sales approved by the bankruptcy court. NNI has operated its businesses as going concerns and has maintained operations in support of the transition of the businesses sold. Eventually, NNI expects to confirm a plan which may result in a liquidating trust to wrap up the litigation and affairs remaining from the bankruptcy. Given the complex nature of NNI's operations, litigation and settlement activity to address, among other things, employee commitments, and issues with multi-jurisdictional insolvency proceedings, application of liquidation basis accounting to NNI's reporting would not be meaningful or reasonably feasible.

Although the accounting prescribed in ASC Section 852-10-05-2 indicates that it only applies to "entities that have filed petitions… and expect to reorganize as going concerns", NNI applied the requirements of ASC Section 852 to its financial reporting because to do otherwise would not have provided meaningful information to the many parties in interest to the NNI bankruptcy cases.

Even in the case of a Liquidating Eleven, some form of reorganized entity may result. Prior to selling its patent portfolio, NNI contemplated reorganizing around a new company which would license its technology. Despite the sale of most of its businesses and intellectual property, there are still options available to NNI to emerge from bankruptcy with a reorganized entity.

In light of examples such as NNI, we believe that no case in Chapter 11 prior to either the effective date of a confirmed plan or conversion to a case under Chapter 7 should qualify for liquidation basis of accounting. Only upon the confirmation of a plan providing for liquidation or the conversion of a Chapter 11 case to a Chapter 7 case should liquidation be considered imminent.

Accepting this premise, ASC Section 852-10-05-02 should be amended to indicate that the reorganization subtopic applies to all entities that have filed petitions with the bankruptcy court under Chapter 11 of the Bankruptcy Code.

205-30-25-4 requires prospective recognition with a cumulative-effect adjustment to the statement of changes in net assets in liquidation. This is inconsistent with the treatment required for entities emerging from Chapter 11 and meeting the requirements of "fresh-start" accounting specified in ASC Section 852-10-45-21, "…the effects of the adjustments on the reported amounts of individual assets and liabilities resulting from the adoption of fresh-start reporting…shall be reflected in the predecessor entity's final statement of operations." Recognizing the effects of commencing a plan of liquidation is more similar than not to the recognition of the effects of implementing a plan of reorganization. Both from an economic view and a practical presentation view, the adjustments transitioning the entity from going concern accounting to liquidation basis accounting should be reflected in the entity's final statement of operations. The decision to adopt a plan of liquidation belongs to the period prior to the commencement of the liquidation. Presenting a statement of changes in net assets available for liquidation that begins with assets and liabilities presented on a going concern basis is inconsistent with measuring the effects of changes in the net assets available for liquidation. We believe that the cumulative effect of adopting liquidation basis accounting should be reflected in the final statement of operations of the reporting entity.

***Comment Letter** continues on p. 8*

Comment Letter continued from p. 7

Initial Measurement

Liabilities should not be measured to reflect the estimated amount of cash or other consideration that the entity expects to pay. The absence of available assets to settle liabilities does not absolve the entity of its obligations. Liabilities should be measured on the same basis or analogous to the requirements of ASC Section 852-10-45-5. Liabilities affected by the plan of liquidation should be reported at the amount of the entity's legal obligation or sxuch amount subject to a definitive settlement agreement. ASC Section 852-10-45-6 should also be considered in the initial and subsequent measurement of liabilities.

From a practical standpoint, many entities undergoing liquidation may not have the financial wherewithal to undertake a comprehensive valuation of their historic going concern balance sheets. While many assets lend themselves to reasonably accurate estimates of liquidation values obtained on a reasonably cost effective basis, the value in liquidation of some assets, such as intellectual property, can be so speculative that any number applied could be equally misleading. In such cases the guidance here should allow for the continued presentation of assets that are not "valued" and require that those assets be identified along with the reasons therefore for the accounting treatment.

205-30-30-2 and 205-30-30-3: We believe it would be helpful in classifying the costs and income discussed in these two sections if those items were referred to by defined terms. The costs described in 205-30-30-2 may be defined in the Glossary as "Disposal Costs", and the expenses and income described in 205-30-30-3 may similarly be defined as "Liquidation Administration" income and expense. Providing defined terms would provide additional guidance on identifying and classifying these elements.

While 205-30-30-2 provides that the costs to dispose of assets should be accrued and disclosed in aggregate separately from the measurement of those assets, the nature of the accrued costs is important information for the users of liquidation financial statements. The estimate of commission costs on the recovery of accounts receivable differs greatly from the carrying costs, taxes and commissions that could be expected to accompany the liquidation of real estate assets. Disclosure of the breakdown of the aggregate disposal costs should be required in the footnotes to the financial statements. In addition, certain disposal costs may be more appropriately classified as part of the net valuation of the related asset. In situations where the liquidation effort is outsourced, such as in the case of receivable collections to a collection agency, the more appropriate disclosure would be the net cash expected to be received from the collection agency.

Disclosure

- In addition to those disclosures outlined in the Exposure Draft, we believe the following are both meaningful and necessary for users of liquidation basis financial statements:
- A statement, if applicable, that the actual values realized in liquidation may be different from the estimated values in the current financial statements.
- While it may be implied in the plan and valuation description requirements of 205-30-50-1, the disclosures should specifically identify whether the anticipated liquidation and the basis for valuation reflect a forced sale of assets or an orderly liquidation. The addition of such a requirement may require the Master Glossary to include definitions of the terms "forced liquidation" and "orderly liquidation".
- In the financial statements for a liquidating trust or other vehicle created pursuant to a confirmed Chapter 11 plan, continuing disclosure regarding the pre-discharge amount of liabilities or interests (the estimated amount of claims expected to be allowed in the Chapter 11 case), the priority of each class of liabilities or interests and the ongoing recovery claimants have received to date from the liquidating trust as a percentage of their allowed claims.

Other matters

The Exposure Draft is silent on the applicability of discontinued operations accounting to Liquidation Basis financial presentations. We query whether the final standards update should include a statement that the requirements of ASC Section 205-20, *Discontinued Operations,* do not apply to liquidation basis accounting.

In connection with the preparation of a disclosure statement for a plan of reorganization, management and/or the advisors to the debtor will prepare a hypothetical liquidation analysis to estimate what creditors might otherwise receive if the debtor was to be liquidated under Chapter 7 rather than reorganized under Chapter 11 in accordance with the provisions of section 1129(a) of the Bankruptcy Code. This liquidation analysis, often referred to as the best interest of creditors' test, is used to support the determination that creditors are receiving more under a plan proposed under Chapter 11 than they would receive if the debtor were to be liquidated under Chapter 7. This analysis is not dissimilar from the initial statement of net assets in liquidation. We believe that the final standard should contain some reference to the development of the hypothetical liquidation statement and clarify that while the guidance contained in the standard may be useful to developing the hypothetical liquidation statement used in bankruptcy proceedings, differences exist between the hypothetical statement and a statement of net assets in liquidation and that all of the guidance in the standard may not be applicable to various bankruptcy situations. ■

Some Strategic Considerations Under § 1129(a)(10) in the Post-Tribune World

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Section 1129(a)(10) of the Bankruptcy Code requires that "[i]f a class of claims is impaired under the plan, at least one class of claims that is impaired under the plan [must have] accepted the plan, determined without including any acceptance of the plan by any insider," for it to be confirmed. Section 1129(a)(10) acts as a "a statutory gatekeeper barring access to cram down where there is absent even one impaired class accepting the plan." *In re 266 Washington Assoc.*, 141 B.R. 275, 287 (Bankr. E.D.N.Y.). *aff'd*, 147 B.R. 827 (E.D.N.Y. 1992). In other words, "before embarking upon the tortuous path of cram down and compelling the target of cram down to shoulder the risks of error necessarily associated with a forced confirmation, there must be some other properly classified group that is also hurt and nonetheless favors the plan." *Id.*

But in a multi-debtor plan that does not provide for substantive consolidation of the debtors, does § 1129(a)(10) allow the acceptance of a class of impaired creditors of one debtor to carry the day over the dissent of classes of creditors of the other debtors? It depends who you ask.

At least three courts have concluded that § 1129(a)(10) can be satisfied by a single impaired accepting class in a multi-debtor plan. *See JPMorgan Chase Bank, N.A. v. Charter Communs. Operating, LLC (In re Charter Communs.)*, 419 B.R. 221, 266 (Bankr. S.D.N.Y. 2009) (Peck, J.); *In re Enron Corp.*, Case No. 01-16034 (AJG), 2004 Bankr. LEXIS 2549, *234 (Bankr. S.D.N.Y. July 15, 2004) (Gonzalez, J.); *In re SGPA, Inc.*, Case No. 1-01-02609, 2001 Bankr. LEXIS 2291, *21 (Bankr. M.D. Pa. Sept. 28, 2001).

However, two recent Delaware bankruptcy decisions came out the other way, holding that absent substantive consolidation § 1129(a)(10) requires an impaired accepting class for *each debtor* in a multi-debtor plan. *In re JER/Jameson Mezz Borrower II, LLC*, 461 B.R. 293, 302-3 (Bankr. D. Del. 2011) (Walrath, J.); *In re Tribune Co.*, 464 B.R. 126, 183 (Bankr. D. Del. 2011) (Carey, J.). The *Tribune* court discussed the issue at length, 464 B.R. at 181-83, concluding that in light of the rule of construction in § 102(8) of the Bankruptcy Code that "the singular includes the plural," the use of the singular "plan" in § 1129(a)(10) did not foreclose application of the requirement on a per-debtor basis in a non-consolidating joint plan, which, conceptually, "consists of a separate plan for each debtor," *id.* at 182.

The *Tribune* court also distinguished each of *Charter Communications*, *Enron*, and *SGPA*, finding that the "per-debtor" versus "per-plan" determination was not central to any of the decisions. *Id.* In *SGPA*, the objecting creditors argued that § 1129(a)(10) must be applied on a per-debtor basis because the plan did not substantively consolidate the debtors; the court overruled this objection, but in so doing the court "found explicitly that the objecting creditors suffered no adverse effect and that the result would not have changed if the debtors had been substantively consolidated." *Tribune*, 464 B.R. at 181 (citing *SPGA*, 2001 Bankr. LEXIS 2291, at *22). *Charter Communications* involved an objection that certain classes of creditors were "artificially" impaired to gerrymander compliance with § 1129(a)(10); this objection was overruled, but as "either an alternative ruling or *dicta*," the court concluded that it would apply § 1129(a)(10) on a "per-plan" rather than a "per-debtor" basis. *Tribune*, 464 B.R. at 182. *Enron*, which was specifically designated "not for publication" by Judge Gonzalez, applied § 1129(a)(10) on a "per-plan" basis against the backdrop of a global settlement among the debtor, the creditors' committee, the court-appointed examiner, and others, which included a "substantive consolidation component." *Tribune*, 464 B.R. at 181 and n64 (*quoting Enron*, 2004 Bankr. LEXIS 2549, at *235).

Given that the joint administration of chapter 11 cases for procedural purposes does not generally alter substantive rights, it would seem odd if plans that would not be confirmable on a stand-alone basis could become confirmable by virtue of their being aggregated into a single plan document. In light of this, and the fact that reading "plan" in § 1129(a)(10) to encompass multiple "plans" subsumed within a single filing by multiple debtors in a jointly administered case is consistent with the Bankruptcy Code's rules of construction, *Tribune* and *JER/Jameson* appear to have the better of the argument. In any event, until there is definitive guidance from the respective Circuit Courts of Appeals, it is prudent to assume that a multi-debtor, non-consolidating plan without an impaired accepting class for each debtor is at risk of non-confirmation.[1]

Luckily, there are strategic options for managing this risk. As a threshold matter, the plan should ensure that at least one class of claims for each debtor will receive at least some distribution under the plan, so as to avoid deemed rejection under § 1126(g) of the Bankruptcy Code that would render compliance with § 1129(a)(10) impossible.

***Strategic Considerations** continues on p. 10*

1 At least, insofar as the plan impairs classes of creditors of each debtor. If the plan does not impair any classes of creditors of a given debtor, then the requirement of an impaired accepting class would not be applicable to that debtor. *See In re Holley Garden Apts., Ltd.*, 238 B.R. 488, 494 (Bankr. M.D. Fla. 1999) (finding § 1129(a)(10) satisfied where no class of claims was impaired under the plan).

Strategic Considerations *continued from p. 9*

Where creditor apathy or dissent is anticipated, the plan might incentivize acceptance of the plan by including a "death trap" provision conditioning some or all of the distribution to a class upon its acceptance of the plan. *See, e.g, Adelphia*, 368 B.R. at 275-76 (confirming plan with death trap allocating value to assenting classes of equity holders); *In re Zenith Elecs. Corp.*, 241 B.R. 92, 105 (Bankr. D. Del. 1999) (Walrath, J.) (confirming plan with death trap conditioned upon class's approval of third-party releases). *But see, e.g., In re MCorp Financial, Inc.*, 137 B.R. 219, 236 (Bankr. S.D. Tex. 1992) (denying confirmation of plan with death trap allocating value to assenting class of equity holders, finding plan was not fair and equitable with respect to and unfairly discriminated against the class); *In re Allegheny Int'l, Inc.*, 118 B.R. 282, 304 n.15 (Bankr. W.D. Pa. 1990) ("[T]here is no authority in the Bankruptcy Code for discriminating against classes who vote against a plan of reorganization."). Ideally, the consideration to be supplied in connection with the death trap would be consideration that creditors would not be otherwise entitled to receive (e.g., a carve-out from a secured creditor's collateral, or a contribution from a plan sponsor). *See Zenith*, 241 B.R. at 111 (noting that the consideration underlying the death trap provision "would not be available in a liquidation" of the debtor).

To provide an additional check against creditor apathy, the plan could adopt a presumption that when, in a class eligible to vote, no vote was cast, that class would be deemed to accept the plan. *See Tribune*, 464 B.R. at 126 (noting, in dictum, that "deemed acceptance" by a non-voting impaired class may satisfy § 1129(a)(10) "in the absence of objection") (*citing In re Ruti-Sweetwater, Inc.*, 836 F.2d 1263 (10th Cir. 1988); *In re Adelphia Communs. Corp.*, 368 B.R. 140, 260 (Bankr. S.D.N.Y. 2007)). *But see*, *e.g., In re Vita Corp.*, 380 B.R. 525, 527-528 (C.D. Ill. 2008) (holding that class cannot accept a plan absent the affirmative vote of creditors within the class); *In re M. Long Arabians*, 103 B.R. 211, 216 (B.A.P. 9th Cir. 1989) (same). Any such presumption should be made explicit in the solicitation procedures and the disclosure statement, so that the efficacy of the presumption can be vetted prior to solicitation. *See Adelphia*, 380 B.R. at 260 (noting that the presumption in that case "was explicit and well advertised" in the plan, the disclosure statement, and the ballots).

Also, as a further check against creditor dissent, the plan could include a provision permitting the plan proponent to "drop" from the plan any debtor(s) for whom the § 1129(a)(10) requirement cannot be met. *Tribune*, 464 B.R. at 184. This may reduce the perceived hold-up value of a dissenting vote, and shift the risk of non-confirmation back to creditors who, if they do not go along with the proposed plan, may be left behind with no certainty of outcome (apart from possible conversion to chapter 7).

In sum, while the "per-debtor" reading of § 1129(a)(10) adopted by *Tribune* and *JER/Jameson* appears to set a higher bar for plan confirmation in non-consolidating multi-debtor cases, in light of the strategic options available to plan proponents (some of which were suggested by the *Tribune* court), it remains to be seen whether this issue will have a significant impact upon chapter 11 practice.

[Editor's Note: An article providing background information and examination of tax aspects of the Tribune case, "Tax Aspects of the Tribune Company Reorganization" by Forrest Lewis, CPA, appeared in *AIRA Journal*, Vol.26, No. 2, 2012, available online at www.aira.org.]

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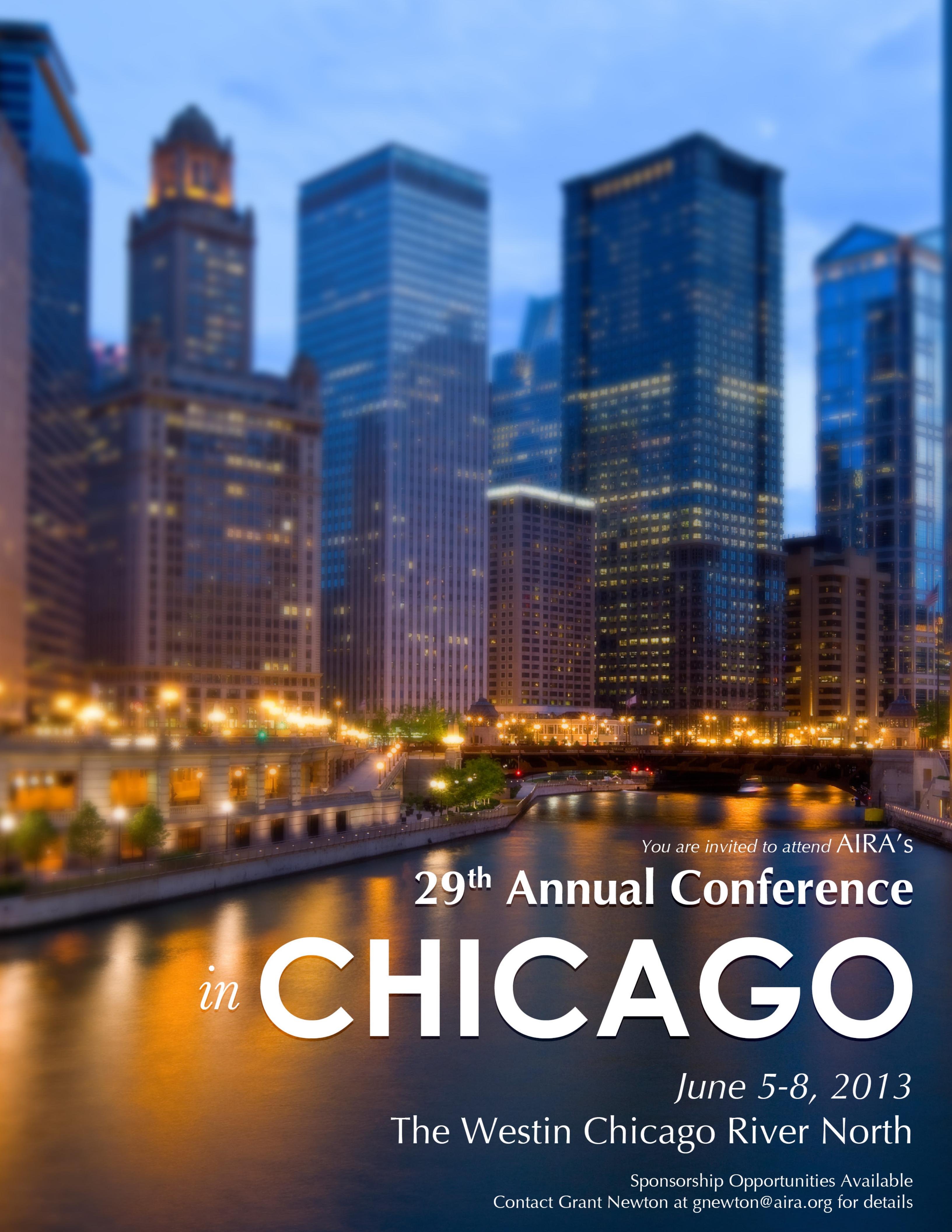
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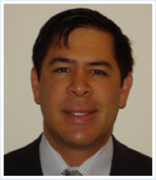
An Introduction to Private Equity Deal Sourcing

Alex Soltani and Matt Thompson
Skyview Capital



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In private equity, deal flow is the lifeblood of each firm. It is crucial to bring a stream of interesting deals into the firm. There are two types of deal leads: proprietary and non-proprietary auctions. Buyout professionals greatly prefer the proprietary, non-auction deals. These proprietary deals, since they are not structured auction processes, have less competition, which can allow for more favorable purchase price and terms.

You can think of deal sourcing like any sales channel. It is a funnel of unqualified leads turning to qualified leads, turning to active discussions, turning to NDA, turning to Letters of Intent, turning to executed transactions. At each stage, only a percentage of deals make it to the next stage. Therefore, if you start with 100 unqualified leads it may only turn into one completed transaction. Since it is a numbers game, it is crucial to generate and efficiently process as many deals as possible. Firms have diverse approaches to deal souring; some have huge in-house teams of deal-sourcing specialists; at some firms all deal professionals are responsible for deal sourcing and execution.

Key Channels to Source Deal Leads

To keep the deal funnel populated it is key to have good deal flow channels. The following are some of the typical deal sourcing channels for private equity sponsors:

1. **Investment Bankers.** Investment Banks are key sources of private equity deal leads. Banks typically run auction processes, which bring a large number of potential buyers.
2. **Consultants.** Strategic and financial consulting firms, like McKinsey, BCG, Bain, FTI Consulting often have corporate finance or restructuring practices which are aware of companies or divisions which are potentially up for sale.
3. **Lawyers.** Lawyers have large networks of clients and are oftentimes aware of upcoming transactions.
4. **Trade Shows.** Trade shows are a great way to meet a large number of companies in targeted sectors. By walking the booths, you can quickly meet hundreds of companies, many of which are looking for funding or acquirers.
5. **Analytical Screens.** Using Capital IQ, Bloomberg, or web searches, you can identify firms that fit your funds investment parameters. These electronic databases can provide contact information for debt and equity securities and for the CEO, CFO, and/or head of corporate development who are aware of possible transactions.
6. **Newspapers, trade magazines and websites.** Some leads come through reading newspaper articles, magazines, or PE-related or industry-specific websites.
7. **Cold-Calling.** A number of private equity firms have an established team of professionals who make outbound calls to businesses looking for companies and divisions for sale. When they target smaller companies they typically call the CEO or CFO of the business. For larger companies, they usually call the head of strategy or corporate development.
8. **Referrals.** Oftentimes, PE firms will provide commissions if a third-party brings them an interesting lead. Sometimes the party bringing in the lead has a proprietary opportunity or has locked up exclusivity with the seller. The further along the referrer has taken the transaction, the higher the commission percentage. These referrals can help supplement the internally generated deal-flow.

The private equity business is getting increasingly competitive, so bringing in more deals is crucial. Once a deal is sourced, negotiated, and closed, the hard work of operating and turning around the business really begins. ■

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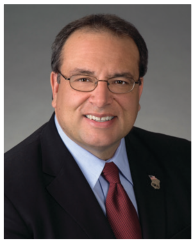

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HALL V. UNITED STATES: WHAT A CHAPTER 12 TAX CASE CAN TEACH US ABOUT THE SUPREME COURT AND THE BANKRUPTCY CODE – PART II

In Part I of this column (see *AIRA Journal*, Vol. 25: No. 6, 2012), I discussed *Hall v. United States,* 132 S. Ct. 1882 (2012). There, the Supreme Court addressed the question of whether Bankruptcy Code section 1222(a)(2)(A) applies to the taxes generated from a postpetition transfer of farm assets; the Court said, No. It reached its 5-4 opinion embracing an approach that, as I observed in Part I, could be found in two earlier chapter 13 cases, thereby exposing an elegant algorithm the Court uses in unlocking meaning from the Bankruptcy Code. I foreshadowed this column by observing that *Hall* and the two chapter 13 cases have changed the intellectual bankruptcy landscape by revealing how the Court engages the Bankruptcy Code. I promised that my analysis would require a jaunt through several disciplines, including farming bankruptcy, cryptography, archaeology, and chapter 13 cases.

Part I considered one of those topics: farming bankruptcies. In this column, the remaining disciplines are visited with an eye toward a robust appreciation of the statutory interpretative "turn" by the Court. Now I plan to show how an understanding of cryptography (and its focus on converting cyphertext into plaintext through the use of cryptovariables), chapter 13 of the Bankruptcy Code, and the importance of context to archaeological praxis shed light on the holding in *Hall*—and teach us important lessons on how the Supreme Court will continue to resolve difficult cases in the margins of the Bankruptcy Code.

Cryptography

Imagine confronting a puzzle in the form of a cypher. You confront such a puzzle in a wilderness of mirrors. Your challenge is to convert the cyphertext—a form not easily understandable by a normal human being—into plaintext—language that is easily understandable by a normal human being. But, of course, you are no normal human being: you are a bankruptcy professional. To convert the cyphertext to plaintext, that is, to unlock the meaning of the gibberish, you need a cryptovariable, or what we mortals call a "key." No key, no meaning; no meaning, no understanding.

Now imagine the Bankruptcy Code as a cypher. Most often, application of the Code to an issue is straightforward. The understanding of the text in the Code is so clear that its interpretation has become effortless. Essentially, we usually read, restate, and describe the Bankruptcy Code when addressing issues. That should not surprise us. Most often, the function of interpreting a text is simply (but not simplistically) to read, restate, and describe. These steps roughly correspond to the questions of what the text says and what the text does.

Occasionally, particularly when dealing with tough cases in the margin of the Code, we ask what the text means. When undertaking this particular task, we are leaving the comfort of restating and describing: we are actively interpreting the text. This endeavor invites a different level of responsibility. There is no escape; one way or another, we are responsible for the meaning we find in our interpretation of the Bankruptcy Code. It is a fundamental truth that the meaning of a text is not given by the text itself. This is no less true with the Bankruptcy Code. That leaves us with the need for a key to unlock the meaning of a text.

Chapter 13

Relatively recently, the Supreme Court considered two chapter 13 cases that along with *Hall* provide the key to unlocking the meaning of the Bankruptcy Code – *Hamilton v. Lanning*, 560 U.S. ___, 130 S. Ct. 2464 (2010) and *Ransom v. FIA Card Service*, 562 U.S. ___, 131 S. Ct. 716 (2011). Thus, to convert the cyphertext in the Code into plaintext, we must take a slightly perilous detour through a confounding wilderness, a trail unfamiliar to many of us in the business bankruptcy world. It requires us to consider chapter 13 of the Bankruptcy Code. OMG.

To those of you who don't know, chapter 13 is a bit more than a filler between chapters 12 and 15. As its title implies, the purpose of chapter 13 is the adjustment of debts of individuals with regular income. Only human beings may file; they must also have regular income. The regular income requirement is necessary because it is this future income by which the chapter 13 plan is funded.

In a chapter 13 case, a debtor keeps all the assets, exempt and non-exempt, and attempts to make payments pursuant to a chapter 13 plan over approximately five years. Further, a chapter 13 trustee operates as a disbursing agent, distributing estate property, including disposable income, in accordance with the terms of the chapter 13 plan. Essentially, a debtor makes one payment to the chapter 13 trustee who then divides the one payment by the debtor to many small payments to the creditors. The chapter 13 plan is generally funded through the debtor's disposable income.

In *Hamilton v. Lanning*, the Supreme Court (8-1) adopted a "forward looking" approach in determining "projected" disposable income in chapter 13 cases. In that case, although the disposable monthly income amount determined on Form B22C (Chapter 13 Statement of Current Monthly Income) was presumptively correct for purposes of "projecting" disposable income, the Supreme Court held that a bankruptcy court could take into account changes in income and expenses that are known or virtually certain to occur. Here is the statutory problem: (1) "disposable income" is defined under the Bankruptcy Code; (2) "projected" is not. One side (the chapter 13 trustee) argued that you follow Form B22C; thus, to get to projected current monthly income, you multiply the amount determined by applying the defined term of current monthly income (which looks back in time at monthly income) by 12 (months), an approach consistent with the literal application of the Bankruptcy Code. The other side (the debtor) argued that when undertaking such a calculation, you should do so with your eyes open so that any anomalies may be considered in projecting disposable income. Here, the debtor had an inflated "Line 59" number because of a one-time buyout from her employer received during the six months prior to filing.

In *Ransom v. FIA Card Service*, the Supreme Court addressed the question of whether a debtor may deduct car ownership costs for a car he owned free and clear in applying the means test. The Supreme Court (8-1) held that in a chapter 13 case, a debtor

Hall v. United States *continues on p. 16*

could only use the applicable deductions for a car loan or lease if the debtor actually had a car loan or lease payment. The court observed that its decision reflects the reality of the debtor's situation, instead of employing a literal application of the formula provided for under the Bankruptcy Code. The Court resolved a circuit split regarding the allowance between the Ninth Circuit, which the Supreme Court affirmed in this case, and three other circuits that had all ruled the allowance applied even to debtors who owned their cars outright.

In both cases, a literal application of the relevant Code section would result in a decision rejected by eight Justices. How can these cases square with a Supreme Court that regularly espouses the importance of the "plain-meaning" approach to understanding the Bankruptcy Code? Enter the key.

An Archaeology of Codes

In *Hall*, *Ransom*, and *Lanning*, the Supreme Court produced the cryptovariable, an approach to unlocking meaning from the Bankruptcy Code in hard cases. The Court suggested that determining what the Bankruptcy Code means (that is, interpreting the Code) requires the interpreter to read the text, excavate the context, and gauge the presumptive meaning against the purpose. Text. Context. Purpose.

(1) Text—The interpreter must begin with the language of the Bankruptcy Code itself. Thus, the plain meaning approach is necessary, but not sufficient, in the interpretative process. Reading a code includes reading the definitions in the Code. If the Code leaves the key term undefined, then it is acceptable to consider other sources like a dictionary (for ordinary meanings) or another federal statute (common in the bankruptcy tax world). Each word within the text must carry meaning, that is, no word is superfluous.

(2) Context—The interpreter next must consider context. Context is literally the weaving together of words. For the Supreme Court, assessing context generally requires consideration of both internal context (the place the relevant term fills within the section), and external context (the place the relevant section fills within the Code or prior practice under the former Bankruptcy Act).

(3) Purpose—After establishing a presumptive interpretation based on text and context, that interpretation is applied to the facts and circumstances at hand. The result of that application is then subject to a test for absurdity. The test generally requires a result be gauged against the purpose of a specific Code section (specific purpose) or the Code itself (general purpose). The scale of purpose (specific or general) is not self-evident. If the presumptive decision leads to an absurd result, the interpretation must be recalibrated by reassessing context. Absurdity here does not mean a simple inconsistency with a stated purpose, a harsh result, or a result that frustrates clear intent; rather, absurdity means ridiculously unreasonable or having no rational relationship to the statutory scheme.

In considering *Hall*, *Ransom*, and *Lanning*, context is the defining characteristic of the Supreme Court's present interpretative approach to the Bankruptcy Code. In statutory interpretation, this is where the issues are joined, where good arguments go to die—the boneyard of the good vanquished by the better.

Archaeology is the pursuit of context over time through the study of the material remains (artifacts, tells, etc.) of humans (including their skeletal remains). To an archaeologist, a pottery shard or statuary rediscovered by excavation is significantly less important than the context in which the item is found. Archaeology is about the appreciation of context. Internal context (what is found with the artifact at the site, its proximity to certain other artifacts, its geo-spatial location) and external context (the comparison of that artifact with others from other sites) are at the heart of the archaeological experience.

It is this appreciation of context that bankruptcy practitioners might borrow from archaeology. Based on the Supreme Court's actual application of the key—text, context, and purpose—context is the pivot. Both *Ransom* and *Lanning* turn on context: the former consulting prior practice and the general meaning of "projected;" the latter consulting the meaning of "applicable" and "expense." Both interpretations (and their counter-interpretations) are then checked against the test of absurdity.

Hall proves the point. The Supreme Court (5-4) reaches its conclusion that section 1222(a)(2)(A) does not strip the priority of an administrative expense in a chapter 12 case because of Internal Revenue Code ("IRC") section 1399 and the meaning of a governmental claim "incurred by the estate." The majority found interpretation of section 1222(a)(2)(A) rests in an appreciation of the context of (1) tax claims, (2) the language "incurred by the estate" found in chapter 12 and chapter 13, and (3) IRC section 1399 that disregards the chapter 12 bankruptcy estate as a separate tax entity—all sources of context. The undeniable fact that the majority's interpretation defeats the clear purpose of section 1222(a)(2)(A) and chapter 12 was insufficient to change the presumptive interpretation. The conclusion did not lead to absurd results (according to five Justices); and harsh results or rulings inconsistent with the purpose of the Bankruptcy Code—positions short of absurdity—are insufficient to overcome text and context.

Concluding Remarks

A text is essentially symbols on a page. Readers—judges, attorneys, financial advisors, experts—bring to their reading a basic recognition of these symbols and an understanding of what the words describe. Occasionally, the task requires a greater appreciation of the text, an engagement beyond restatement and description. This engagement—the act of interpretation—requires a deeper understanding of what the words mean in context. Thus it is necessary to examine the oral tradition that accompanies the more obvious written one, and the interpreter must struggle with the words and spaces.

Between a Code and its meaning lies the act of interpretation. The key to unlocking the Code/code is context and not purpose—a valuable lesson drawn from three humble and seemingly unrelated cases before the Supreme Court. ■

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Bankruptcy Taxes

Forrest Lewis, CPA

CHAPTER 13: OFFER IN COMPROMISE DOES NOT TOLL STATUTE ON OLD TAXES

A US Bankruptcy Court in Maine has discharged three year old taxes in a Chapter 13 plan despite Internal Revenue Service contention that an offer in compromise made by the taxpayer/debtor should have tolled the statute of limitations. *Paul George Paradis, Jr., Melanie Irene Paradis, Debtors*., U.S. Bankruptcy Court, D. Maine, 2012-2 U.S.T.C. ¶50,561, (Sept. 10, 2012).

In the Paradis' Chapter 13 wage earners plan, both the IRS and the taxpayers agreed that the IRS had a secured claim in the amount of $30,439.07 for individual income taxes, but there was also an unsecured claim for "old taxes" from 2004-2007. The dispute centered on whether the unsecured balance of the IRS claim is entitled to priority under Bankruptcy Code Sections §§507(a)(8) and §1322(a)(1). All of the old taxes were assessed on or before June 2, 2008. The debtors filed an offer in compromise (OIC) with the IRS on July 7, 2009. It was rejected on August 23, 2010. They filed their voluntary petition for relief under chapter 13 on June 10, 2011.

IRS position

Bankruptcy Code Section 507 on priority taxes, which cannot be discharged, does contain the following tolling provision, i.e., the statute of limitations does stop running for a period:

> An otherwise applicable time period specified in this paragraph shall be suspended for any period during which a governmental unit is prohibited under applicable nonbankruptcy law from collecting a tax as a result of a request by the debtor for a hearing and an appeal of any collection action taken or proposed against the debtor…

The IRS argued that the offer in compromise tolled the statute of limitations meaning that three years had not really expired between the time of the last assessment of the taxes and the filing of the Chapter 13 petition.

Court ruling

The court considered the facts that the parties agreed the tax years in question predated the debtors' bankruptcy filing and that absent a provision extending the three-year period prescribed by §507(a)(8)(A)(i), the relevant returns were last due sufficiently before bankruptcy to escape priority treatment. The debtors had not obtained a filing extension for their 2007 tax return so it was due on April 15, 2008. They filed their petition on June 10, 2011, more than three years later.

The court states:

> There is no extension or tolling provision "built in" to §507(a)(8)(A)(i)…In order for priority treatment to apply under §507(a)(8)(A)(i) the general suspension language of §507(a)(8)'s final paragraph must apply. If an OIC, an event that stops IRS collection processes, is considered a "request for a hearing" initiated by the debtors, the tolling periods described in the final paragraph of the section would apply to the three year lookback period defined in §507(a)(8)(A)(i)…[however] the term "request by the debtor for a hearing" does not include the debtor's initiation of an OIC.

The court goes on to point out that Congress expressly provided for the OIC process in §507(a)(8)(A)(ii), stating that although the general extension paragraph outlines three specific ways in which the running of §508(a)(8) time periods will be suspended ("request … for a hearing," stay effected by prior cases, and provisions of confirmed plans), it does not mention OICs. The court further stated the OIC process in and of itself entails no hearing but rather is an administrative proposal, evaluation, and negotiation to determine if the IRS will accept a longer payment period or a lesser amount than the full tax due.

> It stands apart from more formal procedures which include requests for a hearing that attempt to challenge or forestall a Notice of Levy….Thus, because I conclude that the debtors' OIC did not constitute a "request … for a hearing" so as to extend the three-year lookback period, the unsecured IRS tax claims, which arise from returns last due April 15, 2008 and before, are not entitled to priority under §507(a)(8)(A)(i).

The court concludes it plainly appears that no part of the IRS's unsecured claim is entitled to priority under §1322(a)(2) and thus holds that upon successful completion of the plan and entry of discharge the unsecured tax obligations will be discharged.

IRS OFFERS MAJOR RELIEF ON WRITTEN CLIENT TAX ADVICE

Practitioners have complained since 2004 about the strict Internal Revenue Service regulations on tax advisers for issuing written advice on federal tax matters. One facet of those regulations is the ubiquitous use of the so called "Circular 230 notice" paragraph which usually begins "Absence of federal tax penalty protection" and generally is included in the email signature of every tax accountant and attorney in the country. IRS has finally relented by proposing a major liberalization of those regulations. While IRS says it is not going back to pre-2004 practices, it has generally returned to a "reasonableness" standard of tax practitioner behavior and is eliminating the "Circular 230 notice" and definition of "covered opinion" which has been at the heart of the problem. REG-138367-06.

The most important provisions of the proposed regulations include:

1. A very simple overarching standard of practitioner competence:

    > §10.35 Competence.
    >
    > A practitioner must possess the necessary competence to engage in practice before the Internal Revenue Service. Competent practice requires the knowledge, skill,

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thoroughness, and preparation necessary for the matter for which the practitioner is engaged.

2. Elimination of the definition of "covered opinion," which was very detailed and nebulous. It created a chilling effect on tax advice in which generally only the largest law and accounting firms would issue a tax opinion letter to a client on which the client could rely for abatement of penalties under IRC Section 6664 concerning relying on advice of a tax adviser. The 2004 regulations created a regime which distinguished between a limited scope opinion which contained a position which had "substantial authority," generally thought to be a 40 percent chance of success, and a much more comprehensive opinion in which the position had to be "more likely than not"—i.e., more than 50 percent chance of success. Under those regulations, a taxpayer could only rely on the latter extensive and expensive opinion letters to avoid penalty. It remains to be seen what types of opinions will evolve under the new regulation.
3. The regulations still retain a higher standard of diligence for tax shelter opinions.
4. The regulations continue to prohibit consideration of the "audit lottery" in providing a written opinion but they would permit consideration of possibilities of a settlement; e.g., certain expenses might be allowed and certain expenses might be disallowed.
5. The proposed regulation requires that an attorney or accountant provide IRS a statement that he or she is duly licensed and not under suspension in any form, in order to practice before IRS, apparently meaning representation in an audit or request for letter ruling.

Conclusion

Any relief from the 2004 regulations will be very welcomed by practitioners. Since the regulations are newly proposed, we have a long way to go before we know the exact effect on future tax practice. I probably will not drop the Circular 230 notice from my communications until new regulations are finalized.

PRINCIPLES OF CONSOLIDATED TAX RETURNS

Sometimes the workings of the Internal Revenue Service Consolidated Return Regulations under Internal Revenue Code Section 1502 are a little mysterious. The purpose of this article is to provide highlights of those rules and illuminate the policy behind some of them. Those of you who studied consolidation in financial accounting will recognize that the IRS tax rules rest largely on those accounting rules.

- In order to elect consolidated group tax return treatment, a corporate group consisting of at least two corporations, one owning 80 percent or more of the other, must elect by timely filing Form 1122 attached to its first group tax return. And yes, the IRS is aware of games which can be played by corporations attempting to drop in or out of the group by changing ownership above and below the 80 percent mark and has a variety of tools to prevent that.
- These days it is quite common to have an assortment of disregarded entities, usually single member LLCs, and partnerships hanging off the corporate group.
- The intent of the regulations is that all 80 percent or more members of the group are generally treated as divisions of a single corporation, meaning that all income and loss within the group can be netted together and income from intercompany transactions is minimized. Obviously in the common situation where some corporations are making money and others are losing, the netting is a very desirable tax saving device.
- In contrast to financial accounting, intercompany transactions which only affect the current year are "left in" the accounts and not netted out since their effect on a group basis is offsetting. Intercompany dividends are excluded from income but they reduce subsidiary basis. For intercompany transactions affecting more than one year, tax effects are minimized by a system of "deferred gains and losses." [Note: Like many practitioners, the author prefers to use the older terminology of the pre-1995 regulations. The correct current terminology is "to take into account the corresponding items."]

  The Regulations contain a "matching principle." For example, if Subsidiary S sells a vehicle to Subsidiary B at a gain, S's gain is deferred and taken into income ratably along with the corresponding depreciation of the vehicle it created in B.
- To further illustrate, if the "deferred intercompany gain" will not normally be recognized for tax purposes under the matching rule, the 1995 regulations include an "acceleration principle" which is one of the tax traps for the unwary. Example: Subsidiary B pays Subsidiary S for providing substantial administrative and clerical services involved in Subsidiary B's acquisition of yet another subsidiary in a nontaxable Type B (stock for stock reorganization). Subsidiary B must capitalize the amount paid to Subsidiary S in its acquisition cost of the new subsidiary. Under the acceleration principle, since there is no definite schedule or amortization for the capitalized costs, Subsidiary S must immediately include the service revenue in taxable income and there will be no offsetting expense, i.e. a net increase in consolidated taxable income.
- One difficult aspect of the rules is that they still require each corporation to track all its "separate" tax attributes such as its share of any consolidated net operating loss carryover, asset basis, earnings & profits, etc. so that the corporation can carry those attributes with it if it is sold or spun off.
- Although accumulated net operating losses of a corporation generally carry forward in a purchase of the corporation or taxfree acquisitive reorganization, many provisions have been added to the tax law to limit "trafficking in net operating losses." In the consolidated return area, two primary limits on using NOLs are Section 382 which applies to any corporate acquisition and the "separate return limitation year" (SRLY) rules which apply only to consolidated groups. Generally one or the other will apply to any acquisition by a group of a corporation with a NOL carryforward or any acquisition

of a group with a NOL carryforward. Section 382 limits the future use of any NOL carryforward by an amortization method based on the fair market value on date of acquisition and the IRS interest rate. The SRLY rules limit the use of a NOL of an acquired corporation to the net income generated by that corporation in the future.

- As part of that separate corporation tracking, each corporation which owns another must keep track of its investment or tax basis in the subsidiary. Overall, this is good because it tends to conform "outside" stock basis with "inside" asset basis. However, this can lead to another tax trap in consolidated groups known as an "excess loss account" or ELA. When the group uses a subsidiary's loss to reduce group taxable income, the immediate parent of that subsidiary reduces its basis in the sub by the amount of the loss used. That can lead to a sort of "negative basis" called an excess loss account. When a subsidiary with an excess loss account is disposed of or is the subject of a worthless stock deduction by the parent, the amount of the excess loss account is taken into income.
- A major line in the sand drawn by IRS in consolidated group transactions is preventing "bust ups." IRS has long taken the position that the Internal Revenue Code requires that when a consolidated group of corporations is purchased all of the tax basis of the buyer is attached to the stock in the newly acquired "parent" of the group (outside basis). There is no "push down accounting" for tax purposes, all inside tax basis below the parent stock remains the same. This prevents the acquirer from executing a "bust up", allocating the purchase price for tax purposes to subsidiaries it wants to sell immediately without tax consequence. Example: Medium Group has $20 million basis in each of its two subsidiaries, Hot Company which is worth $70 million and Slowpoke, Inc. which is worth $30 million. Big Corp. buys all the stock of Medium Group for $100 million, mainly to get Hot Company. It doesn't want Slowpoke but will have to recognize a $10 million taxable gain ($30 million - $20 million) to sell it.
- In recent years, the IRS has gone on another crusade known as the "loss disallowance rules" or "unified loss rules" primarily dealing with sales or dispositions of subsidiaries which result in duplicated losses. Because of the differences between inside and outside basis, some losses on disposition of a subsidiary will be duplicated. Example: Parent capitalizes a subsidiary with $100 and buys a parcel of land for $100 with a view to developing it. The parcel of land later loses value and the Parent gives up on it, selling the subsidiary for $60, deducting a $40 loss. The buyer now holds a corporation with a parcel of land with an inside tax basis of $100 and a value of $60, a $40 built-in loss which duplicates the loss the original Parent already deducted. The IRS has adopted very complicated and arduous regulations to combat this perceived abuse which are beyond the scope of this article. Suffice it to say, when those regulations apply they call for either an outside basis reduction, an inside basis reduction or a net operating loss carryover reduction.

Conclusion

Although the age of the C corp may be fast passing away, filing consolidated returns is still a valuable technique for their tax management. However, the IRS continues to tighten its regulations and make their understanding and application more difficult. ■

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Bankruptcy Cases

Professor Baxter Dunaway

FIFTH CIRCUIT

Does conduct requirement of exception to bankruptcy discharge under 11 U.S.C.A. § 523(a)(1)(C) for willfully attempting to evade or defeat tax include willful attempts to evade or defeat the payment or collection of taxes, in addition to their assessment?

The Fifth Circuit agreed with sister circuits that the plain language of 11 U.S.C.A. § 523(a)(1)(C) including the "willfully attempted" exception "contains a conduct requirement (that the debtor 'attempted in any manner to evade or defeat [a] tax'), and a mental state requirement (that the attempt was done 'willfully')." *U.S. v. Coney*, --- F.3d ----, 2012 WL 3011150, 110 A.F.T.R.2d 2012-5351, 2012-2 USTC P 50,482 (5th Cir.(La.) Jul 24, 2012) (NO. 11-30387); *Fretz,* 244 F.3d at 1327 (citing *In re Fegeley,* 118 F.3d 979, 983 (3d Cir.1997)).

FOURTH CIRCUIT

Did the 2005 Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) effect an implied repeal of the "absolute priority rule" for individual debtors proceeding under Chapter 11?

In this direct appeal from the Bankruptcy Court, the Fourth Circuit addressed a question of first impression in the circuit courts of appeal: whether, in light of the 2005 amendments to the Bankruptcy Code, 11 U.S.C. § 101 *et seq.* ("the Code"), codified by the Bankruptcy Abuse Prevention and Consumer Protection Act ("BAPCPA"), Pub.L. No. 109–8, 119 Stat. 23 (2005), the absolute priority rule continues to apply to individual debtors in possession proceeding under Chapter 11. Because the Court of Appeal answered that question in the affirmative, the Court affirmed the bankruptcy court's order denying plan confirmation. *In re*

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Maharaj, 681 F.3d 558, 56 Bankr.Ct.Dec. 166 (4th Cir.(Va.) Jun 14, 2012) (NO. 11-1747).

Under the now-operative provisions of the Code, a bankruptcy case under Chapter 11 commences with the filing of a Chapter 11 petition in the bankruptcy court. 11 U.S.C. § 301. Commencement of the case creates the bankruptcy estate, which includes, pursuant to 11 U.S.C. § 541(a)(1), "all legal or equitable interests of the debtor in property as of the commencement of the case." *In re Maharaj*, 681 F.3d 558, at 561-2.

After filing a voluntary petition under Chapter 11, a debtor may file a plan of reorganization with the bankruptcy court. 11 U.S.C. § 1121(a). In addition to numerous other requirements, a reorganization plan must specify classes of claims against the debtor based on specific statutory requirements. 11 U.S.C. § 1123(a)(1). To be operative, a Chapter 11 reorganization plan must be confirmed by the bankruptcy court. A precondition of plan confirmation is that it meet the requirements set forth in 11 U.S.C. § 1129(a). *In re Maharaj*, 681 F.3d 558, at 562.

Of particular import to this case is the requirement, found at § 1129(a)(8)(A), that each impaired class of creditors accept the plan. Pursuant to § 1129(b), however, a plan of reorganization may be confirmed over the dissent of an impaired class of creditors using a procedure commonly known as a "cram down." The plan can avoid the requirements of § 1129(a)(8) in a cram down procedure "if the plan does not discriminate unfairly, and is fair and equitable" to the dissenting creditors. 11 U.S.C. § 1129(b)(1). *In re Maharaj*, 681 F.3d 558, at 562.

The Code inclusively sets forth, at § 1129(b)(2), specific requirements that must be met for a plan to be "fair and equitable." Among those requirements is the "absolute priority rule", the construction of which is central to the disposition of this appeal. Prior to 2005, the absolute priority rule (as codified) was simply that, in order to be fair and equitable, a proposed Chapter 11 plan must provide: "the holder of any claim or interest that is junior to the claims of such [dissenting] class will not receive or retain under the plan on account of such junior claim or interest any property." 11 U.S.C. § 1129(b)(2)(B)(ii). In other words, if the proposed plan allowed the debtor to retain property, any dissenting creditors must be paid in full in order for the plan to be "crammed down." *See Ahlers,* 485 U.S. at 202, 108 S.Ct. 963. *In re Maharaj*, 681 F.3d 558, at 562.

In 2005, Congress enacted BAPCPA, which has been previously described as an "attempt to reduce the spiraling costs to society of bankruptcies." *In re Ciotti,* 638 F.3d 276, 279 (4th Cir.2011). Although Congress, in enacting BAPCPA, altered the Code in numerous respects, the focus in *In re Maharaj* is the amendment to § 1129(b)(2)(B)(ii), which contains the absolute priority rule. The Code, after BAPCPA, now states that to be fair and equitable, a proposed plan must provide that:

> the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property, *except that in a case in which the debtor is an individual, the debtor may retain property included in the estate under section 1115, subject to the requirements of subsection (a)(14) of this section.*
>
> *Id.* (2005 amendment emphasized). *In re Maharaj*, 681 F.3d 558, at 562.

Section 1115 (which was added to the Code by BAPCPA) in turn provides:

> (a) In a case in which the debtor is an individual, property of the estate includes, in addition to the property specified in section 541—
>
> (1) all property of the kind specified in section 541 that the debtor acquires after the commencement of the case but before the case is closed, dismissed, or converted to a case under chapter 7, 12, or 13, whichever occurs first; and
> (2) earnings from services performed by the debtor after the commencement of the case but before the case is closed, dismissed, or converted to a case under chapter 7, 12, or 13, whichever occurs first.
>
> (b) Except as provided in section 1104 or a confirmed plan or order confirming a plan, the debtor shall remain in possession of all property of the estate.
>
> 11 U.S.C. § 1115. *In re Maharaj*, 681 F.3d 558, at 562-3.

A significant split of authorities has developed nationally among the bankruptcy courts regarding the effect of the BAPCPA amendments on the absolute priority rule when the Chapter 11 debtor is an individual. Some courts have adopted the "broad view" that, by including in § 1129(b)(2)(B)(ii) a cross-reference to § 1115 (which in turn references § 541, the provision that defines the property of a bankruptcy estate), Congress intended to include the entirety of the bankruptcy estate as property that the individual debtor may retain, thus effectively abrogating the absolute priority rule in Chapter 11 for individual debtors. Other courts, adopting the "narrow view," have held that Congress did not intend such a sweeping change to Chapter 11, and that the BAPCPA amendments merely have the effect of allowing individual Chapter 11 debtors to retain property and earnings acquired after the commencement of the case that would otherwise be excluded under § 541(a)(6) & (7).[1] To date, one district court, one bankruptcy appellate panel, and five bankruptcy courts have taken the "broad view" and ruled, although on different grounds, that Congress intended abrogation of the absolute priority rule. *See In re Friedman,* 466 B.R. 471 (9th Cir.BAP 2012); *SPCP Group, LLC v. Biggins,* 465 B.R. 316 (M.D.Fla.2011); *In re Shat,* 424 B.R. 854 (Bankr.D.Nev.2010); *In re Johnson,* 402 B.R. 851 (Bankr.N.D.Ind.2009); *In re Tegeder,* 369 B.R. 477 (Bankr.D.Neb.2007); *In re Roedemeier,* 374 B.R. 264 (Bankr.D.Kan.2007); *In re Bullard,* 358 B.R. 541 (Bankr.D.Conn.2007). *In re Maharaj*, 681 F.3d 558, at 563.Some of these "broad view" courts have ruled Congress intended abrogation on the basis of the "plain" language of § 1129(b)(2)(B)(ii). In *Biggins,* for example, the district court reasoned:

> [s]ection 1115 says that "property of the estate includes, in addition to the property specified in section 541–(1) all property of the kind specified in section 541 that the debtor acquires after the commencement of the case," as well as "(2) earnings from services performed by the debtor after the commencement of the case." The *plain reading* of this statute is that "property of the estate," for purposes of Section 1115, includes property acquired and earnings earned after

1 "We [Fourth Circuit] adopt the terminology frequently used by commentators and courts writing on the post-BAPCPA status of the absolute priority rule. That is, the "broad view" represents a finding that the absolute priority rule has been abrogated by BAPCPA, while the "narrow view" holds no abrogation has occurred." *In re Maharaj*, 681 F.3d 558, at 563, FN5.

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the debtor files his or her Chapter 11 petition, in addition to property specified in section 541.... Reading these statutes together, "property of the estate" for purposes of Section 1115 includes property and earnings acquired both before and after the commencement of the bankruptcy case.

465 B.R. at 322 (emphasis added); *see Tegeder,* 369 B.R. at 480 ("Since § 1115 broadly defines property of the estate to include property specified in § 541, as well as property acquired post-petition and earnings from services performed post-petition, the [absolute priority] rule no longer applies to individual debtors who retain property of the estate under § 1115."). The *Friedman* panel majority reached a similar conclusion based on its reading of the plain meaning of the words "included" and "in addition to" in § 1115: *In re Maharaj*, 681 F.3d 558, at 564.

> "Included" is not a word of limitation. To limit the scope of estate property in §§ 1129 and 1115 would require the statute to read "included, except for the property set out in Section 541" (in the case of § 1129(b)(2)(B)(ii)), and "in addition to, but not inclusive of the property described in Section 541" (in the case of § 1115).A *plain reading* of §§ 1129(b)(2)(B)(ii) and 1115 together mandates that the [absolute priority rule] is not applicable in individual chapter 11 debtor cases.
>
> *Friedman,* 466 B.R. at 482 (emphasis added) (footnote omitted).

On the other hand, over a dozen separate bankruptcy courts, including the court below, have adopted the "narrow view" and held that BAPCPA did not abrogate the absolute priority rule in its entirety for individual Chapter 11 debtors. *See In re Arnold,* 471 B.R. 578, 2012 WL 1820877 (Bankr.C.D.Cal. May 17, 2012); *In re Tucker,* 2011 WL 5926757 (Bankr.D.Or.2011); *In re Borton,* 2011 WL 5439285 (Bankr.D.Idaho 2011); *In re Lindsey,* 453 B.R. 886 (Bankr.E.D.Tenn.2011); *In re Kamell,* 451 B.R. 505 (Bankr.C.D.Cal.2011); *In re Draiman,* 450 B.R. 777 (Bankr.N.D.Ill.2011); *In re Maharaj,* 449 B.R. 484 (Bankr.E.D.Va.2011); *In re Walsh,* 447 B.R. 45 (Bankr.D.Mass.2011); *In re Stephens,* 445 B.R. 816 (Bankr.S.D.Tex.2011); *In re Karlovich,* 456 B.R. 677 (Bankr.S.D.Cal.2010); *In re Steedley,* 2010 WL 3528599 (Bankr.S.D.Ga.2010); *In re Gelin,* 437 B.R. 435 (Bankr.M.D.Fla.2010); *In re Mullins,* 435 B.R. 352 (Bankr.W.D.Va.2010); *In re Gbadebo,* 431 B.R. 222 (Bankr.N.D.Cal.2010).In reaching these decisions, courts have stated differing rationales as to why the absolute priority rule remains valid in individual Chapter 11 cases. no clear indication that Congress intended to abrogate the longstanding absolute priority rule for individual Chapter 11 debtors.

In ruling that there was no clear indication that Congress intended to abrogate the longstanding absolute priority rule for individual Chapter 11 debtors The Fourth Court of Appeals concluded:[2]

> Looking to the text of both §§ 1129(b)(2)(B)(ii) and 1115, we find no clear indication that Congress intended to abrogate the longstanding absolute priority rule for individual Chapter 11 debtors. As we discussed above, the language at issue is ambiguous, and we are unable to draw from it a clear Congressional intent to abrogate the rule. To the contrary, we are in agreement with those courts that have concluded that, if Congress intended to abrogate such a well-established rule of bankruptcy jurisprudence, it could have done so in a far less convoluted manner. As the *Kamell* court persuasively observed:
>
> > [T]he [absolute priority rule] or something very like it has been acknowledged as far back as at least the 1890's. It has long been held that major changes to existing practice will not be inferred unless clearly mandated. Further, as observed by the U.S. Supreme Court when it upheld application of the [absolute priority rule] in *Norwest Bank Worthington v. Ahlers,* despite the newly enacted Chapter 12, "where, as here, Congress adopts a new law ... it normally can be presumed to have had knowledge of the interpretation given to the old law." From such awkward and convoluted language the court cannot infer that Congress truly intended such a wide and important change in individual Chapter 11 practice as discarding the [absolute priority rule].

451 B.R. at 509–10 (internal citations, alterations, and quotation marks omitted).

THIRD CIRCUIT

Applying Schwab v. Reilly, 130 S. Ct. 2652, 177 L. Ed. 2d 234, 53 Bankr. Ct. Dec. (CRR) 78, Bankr. L. Rep. (CCH) P 81787 (2010), *does claiming as exempt a value equal to the scheduled value of an asset exempt only the scheduled value and not the asset itself and postpetition appreciation belongs to the estate?*

Third Circuit, applying *Schwab v. Reilly*, 130 S. Ct. 2652, 177 L. Ed. 2d 234, 53 Bankr. Ct. Dec. (CRR) 78, Bankr. L. Rep. (CCH) P 81787 (2010), holds that claiming as exempt a value equal to the scheduled value of an asset exempts only the scheduled value and not the asset itself and that postpetition appreciation belongs to the estate. In re Orton, 687 F.3d 612, Bankr. L. Rep. P 82,256 (3rd Cir.(Pa.) Jul 20, 2012) (NO. 11-4157).

Merely exempting dollar amount in oil and gas lease equal to Schedule B estimated value was insufficient to manifest intent to exempt entire asset, and thus debtor's dollar-amount exemptions merely gave him interest in oil and gas lease; although debtor listed amount that happened to constitute lease's actual fair market value, which was within statutory limits for exemption, dollar-amount exemptions did not adequately give notice to trustee of debtor's intent to fully exempt his interests in lease, and, therefore, trustee did not have to object to debtor's exemptions to retain ability to except lease from abandonment. 11 U.S.C.A. §§ 522, 541.

See also, Dollar-Amount Exemptions Gave Debtor Interest in Lease, 08-8-12 West's Bankruptcy Newsletter 6 (2012).

THIRD CIRCUIT

Are retail sales taxes collected by debtor from third parties "trust fund" taxes, rather than "excise" taxes, and are therefore nondischargeable in bankruptcy?

The Third Circuit Court of Appeals followed three sister court of appeals in ruling that Retail sales taxes collected by debtor from third parties were "trust fund" taxes, rather than "excise" taxes, and were therefore nondischargeable in bankruptcy. Taxes collected by retailer never become the property of the retailer, who retains the funds in trust for the state. 11 U.S.C.A. § 507(a)(8). In re Calabrese, --- F.3d ----, 2012 WL 2948545, 56 Bankr.

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2 681 F.3d 558, at 571-2.

Ct.Dec. 224, Bankr. L. Rep. P 82,255 (3rd Cir.(N.J.) Jul 20, 2012) (NO. 11-3793).

The Third Circuit considered for the first time whether retail sales taxes are "excise" taxes or "trust fund" taxes under the Bankruptcy Code. The distinction is significant because trust fund taxes are never dischargeable in bankruptcy. *See* 11 U.S.C. §§ 507(a)(8)(C), (E), 523(a)(1)(A).. Three sister courts of appeals have considered the question presented here. In each case, the court determined that the statutory text of § 507(a)(8) does not resolve the dispute. *See Shank v. Wash. State Dep't of Revenue, Excise Tax Div. (In re Shank),* 792 F.2d 829, 832 (9th Cir.1986); *DeChiaro v. N.Y. State Tax Comm'n,* 760 F.2d 432, 435 (2d Cir.1985); *Rosenow v. State of Ill., Dep't of Revenue (In re Rosenow),* 715 F.2d 277, 279 (7th Cir.1983). Proceeding to analyze the legislative history, all three concluded that a sales tax paid by a third party is a trust fund tax within the meaning of subsection (C), and not an excise tax under subsection (E).

In sum, the Third Circuit believed public policy concerns weigh against the appellant Calabrese, primarily because sales taxes collected by a retailer never become the property of the retailer; *ab initio,* it retains those funds in trust for the state. Accordingly, the Court held that Calabrese's sales-tax obligation is subject to § 507(a)(8)(C) and is not dischargeable. The Court affirmed the order of the District Court. In re Calabrese, --- F.3d ----, 2012 WL 2948545, *9.

EIGHTH CIRCUIT

Is judgment creditor's construction judgment debt nondischargeable under 11 U.S.C.A. § 523(a)(4) and State statute?

The Eighth Circuit Court of Appeals held that Minnesota statute which created lien relationship between contractor and subcontractor did not create express trust cognizable under federal statutory provision barring a Chapter 7 debtor's discharge of debts in bankruptcy for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny because of Minnesota statute's express bar against the creation of a fiduciary relationship. 11 U.S.C.A. § 523(a)(4); M.S.A. § 514.02. In re Thompson, 686 F.3d 940, 56 Bankr.Ct.Dec. 236 (8th Cir. Jul 30, 2012) (NO. 11-3397).

See also: Who Is Acting in ""Fiduciary Capacity"" Within Meaning of Fraud or Defalcation Discharge Exception in Bankruptcy (11 U.S.C.A. s523(a)(4))--Fiduciary Capacity of Debtors Involved in Sale, Purchase, or Lease of Goods or Services Other than Legal, Financial, Investment, or Banking Products or Services, 15 A.L.R. Fed. 2d 337 (2007). ■

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Grant Thornton LLP
New York, NY

Joseph Saitta
Mesirow Financial Consulting, LLC
New York, NY

Joshua Shilts
Morrison, Brown, Argiz & Farra
Miami, FL

Jacob Sizemore
Greer & Walker, LLP
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Michael Spaulding
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Alvarez & Marsal, LLC
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Michael Tebesceff
Loughlin Management Partners + Company
New York, NY

Thomas Welsh III
FTI Consulting, Inc.
New York, NY

Erik White
FTI Consulting, Inc.
Dallas, TX

CLUB 10

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