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Journal

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ISSUES AND PITFALLS RELATING TO THE RETENTION OF FINANCIAL ADVISORS, RESTRUCTURING CONSULTANTS AND ACCOUNTANTS

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The United States Bankruptcy Code (the "Code")[1] and the Bankruptcy Rules (the "Rules")[2] set forth the manner in which professionals who seek to be retained by a Trustee, Creditors Committee or a Debtor must operate. Section 327(a) of the Bankruptcy Code provides:

> The trustee, with the court's approval, may employ... professional persons, that do not hold or represent an interest adverse to the estate, and that are disinterested persons, to represent or assist the trustee in carrying out the trustee's duties under this title.

11 U.S.C. § 327(a).

Disclosure Under Bankruptcy Rule 2014:
Rule 2014, provides, in pertinent part:

> The application shall state the specific facts showing_the necessity for the employment, the name of the person to be employed, the reasons for the selection, the professional services to be rendered, any proposed arrangement for compensation, and, to the best of the applicant's knowledge, all of the person's connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee. The application shall be accompanied by a verified statement of the person to be employed setting forth the person's connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee.

When a trustee, debtor or creditors committee seeks to hire a professional, an employment retention application must reveal all connections between the professional and the debtor, the creditors and any other party of an interest, including the case trustee and the United States trustee, as well as any connection that may exist between the professional and any accountant or attorney for the debtor, a creditor, or other party of interest. In determining whether there has been compliance with the requirements of Rule 2014(a) it is the degree of completeness of the disclosure, rather than the applicants' subjective intent or state of mind with respect to disclosure, that is material. See In Re Begun, 162 B.R. 168 (Bankr. N.D. 1Il. 1993).

Failure to disclose a connection with a party of interest is sanctionable. Even a negligent or inadvertent failure to fully disclose relevant information may result in denial of all requested fees. In Re Park-Helena Corp., 63 F.3d 877(9th Cir. 1995) Cert. denied, 516 U.S. 1049 (1996).

Rule 2014 and Code §327 mandate disclosure of potential as well as actual conflicts of interest. Hansen, Jones, Leta, PC v. Segal 220 B.R, 434 (D. Utah 1998). Although Rule 2014 does not expressly require supplemental or continuing disclosure, Code §327 (a) implies a duty of continuing disclosure. Near boiler plate statements disclosing perspective connections is rarely satisfactory. See In Re Granite Partners, LP 219 B.R. 22 (Bankr. S.D.N.Y. 1998).

It is not left to the discretion of the professional to pick and choose those connections which they deem relevant to disclose; rather they must disclose all facts that bare on the issue of disinterestedness. In Re Granite Partners, 219 B.R. at 35. Applicants and their professionals must strictly comply with Rule 2014. Failure to disclose all connections provides a basis to disallow fees and even disqualify the professional. See In Re Leslie Fay, 175 B.R. 525 (Bankr. S.D.N.Y. 1995). The Court in Leslie Fay noted: "the requirements of Fed. R. Bankr. P. 2014 are more-encompassing then those governing the disinterestedness inquiry under §327. For a while retention under §327 is only limited by

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1 All references to the "Code" refer to 11 U.S.C. §§101 et al., as amended.

2 All the reference to the Bankruptcy Rules refer to Fed. R. Bankr. P. 101 et al., as amended.

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In This Issue

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Letter from the President

Grant T. Stein
Alston & Bird LLP

The start of 2010 has been an interesting time for our industry. The level of intensity and the volume of actual bankruptcy filings appears to have declined for many, but equaling the past two years is not a goal the general economy would like to see achieved. I am writing this on the same day that Senator Evan Bayh of Indiana resigned from the Senate on the basis that our current system in Washington is not working due to extreme partisanship. Taken at face value, this level of frustration should be compared to what we focus on accomplishing as restructuring professionals.

As a broad generalization, what we have seen in the past year is a series of examples of a system that works. Our bankruptcy and insolvency practice is focused on rehabilitation and renewal in most respects. If one were to make a broad statement about the level of cooperation by lenders, the statement might be that many lenders have been patient and cooperative in trying to find solutions to difficult financial dilemmas. Does that happen in every case – of course not. But, broadly speaking, lenders have been practical.

Have the Courts been as practical, or, as some might argue, too pragmatic, in their approach to the cases before them? The January 25, 2010, decision in one of the Lehman Bros. adversary proceedings that the automatic stay and the concept of ipso facto clauses would cross over to apply to non-debtors that were part of a group, and that the safe harbor provisions exempting swap agreements and derivatives from the automatic stay provisions would not apply to changes in priority as a consequence of bankruptcy, can certainly be said to be result oriented, and clearly debtor oriented. One may say the same thing about other decisions such as the District Court's Philadelphia Newspapers ruling on limiting a secured creditor's credit bid rights, while at the same time carefully noting that the interim ruling was not a determination of whether such a structure would meet the fair and equitable test for cramdown of a plan. The Tousa decision is arguably another example of an aggressive use of the Court's fact finding authority in a fraudulent conveyance case that blazed some new territory where the Court found, without much discussion, that the concept of observable market value was a valid approach to value. All of these decisions are subject to appellate review and the continued development of the law in these important areas is definitely taking place.

In summary, our system keeps on working, the courts continue to make significant decisions, and parties find ways to solve their problems and disputes. That is how we are supposed to contribute — by helping the system work and finding solutions. Maybe our collective efforts as restructuring professionals could be a guide to those in Washington about how to work toward constructive resolution. ■

Grant Stein is a partner in Alston & Bird's Bankruptcy, Reorganization and Workouts Group. His diverse practice includes the representation of debtors, secured and unsecured creditors, creditors' committees, and fiduciaries in complex and difficult out-of-court workouts, debt restructurings, bankruptcy cases, and financial transactions throughout the United States and internationally. He also regularly represents officers, directors, and other parties in bankruptcy litigation of all kinds. His restructuring experience includes manufacturing, real estate, wholesale, retail, distribution companies, health care, communications, technology and intellectual property issues.

Mr. Stein is a Fellow of the American College of Bankruptcy and is identified as a top practitioner in Chambers USA: America's Leading Lawyers for Business, The Best Lawyers in America and Super Lawyers magazine. He serves as a director and president-elect of the Association of Insolvency and Restructuring Advisors (AIRA). He also is a director and president-elect for the Southeastern Bankruptcy Law Institute. He recently served as a Member of the executive committee of Emory University's Board of Visitors. He has written numerous articles on bankruptcy and workout issues and regularly lectures around the country. Mr. Stein served as law clerk to The Honorable W. Homer Drake, the senior judge of the United States Bankruptcy Court for the Northern District of Georgia, following his graduation, with honors, from the University of Georgia School of Law in 1981. He received his B.B.A., with high honors, from Emory University in 1978.

Letter from the Executive Director

Grant Newton, CIRA
AIRA

For the last several months I have been working on a basic bankruptcy course that will be available in March for both Self and Group Study. This will expand the AIRA's offerings for professional education, providing a comprehensive yet flexible program to meet a variety of situations and objectives. The course consists of eight parts as follows:

Chapter 1: Nature of the Bankruptcy Process
Chapter 2: Preplanning for and Filing of the Petition
Chapter 3: Issues Related to Operating and Turning Around Troubled Businesses
Chapter 4: Creditor Rights and Claims
Chapter 5: Financial Reporting During Chapter 11 (FASB ASC 852)
Chapter 6: Chapter 11 Plans
Chapter 7: Reporting Requirements Under FASB ASC 852 on Emergence from Chapter 11
Chapter 8: Special Situations Involving Financial Advisors in Recovery Action (such as preferences and fraudulent transfers; forensic accounting)

The group study course includes an instructor's guide with teaching suggestions, PowerPoint slides, exercises and study questions with suggested solutions. The group course is recommended for 5-25 participants.

The self study course is offered as separate modules wherein the participant may register separately for each chapter (Chapters 1-8) or for all eight chapters at once (complete course). Each module completed qualifies for one hour of CPE credit and the complete course qualifies for 8 units of CPE credit.

In Memoriam: Robert Morris

We regret to report that Board of Director member and respected professional associate, Robert Morris, passed away on Saturday, February 20. For many years, Bob was a strong and valued supporter, an important contributor to both the AIRA and CIRA program. He exemplified the Association's objectives and standards and served them for many years, holding both CIRA and CDBV certificates and co-chairing the 2007 Annual Conference in Chicago. Bob worked with MorrisAnderson for the last 12 years, leaving his position recently after being diagnosed with pancreatic cancer last Fall. In addition to his efforts for AIRA, he was also very active as member of TMA. His contributions to the profession spanned an extended time period and impacted many: we have lost a good friend and colleague.

As we enter the final weeks of preparation for AIRA's 26th Annual Conference in the incredible San Diego, California, setting, I look forward to seeing and working with you in June (see AIRA's website for conference information and registration).

Best regards, Grant

Bankruptcy Retakes

Professor Jack F. Williams, CIRA/CDBV
Georgia State University

On Ethics

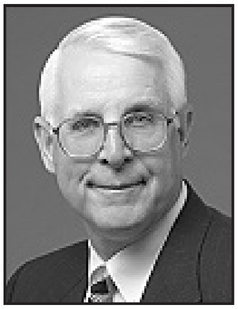
As we begin 2010, I wanted to share with you the subject matter of several recent calls to me by fellow members. These calls focused on ethics in the restructuring profession. All callers were AIRA and CIRA members; thus, any potential ethics issue must be addressed initially by application of our own Code of Professional Ethics (Code) and any other body of ethics that may regulate any other professional certification one may possess. You may find our Code on the AIRA website and in the front of our directory.

Our Code begins with a general statement: "AIRA members and holders of CIRA and CDBV certification are expected to exemplify the highest standards of professional ethics . . . ." Our professional ethics center on the attributes of competence, confidentiality, integrity, objectivity, and due care. I want to address the attributes of competence and due care. At the outset, our Code demands that we apply our knowledge and skill with reasonable care and diligence maintain an appropriate level of professional competence by continuing to develop knowledge and skills. Moreover, the Code requires that we perform professional duties in accordance with the law, regulations, or any technical standards. Our Code then cautions us not to take engagements for which we do not have, nor can we reasonably acquire, the competence to complete.

Along with the requirement that we conduct ourselves competently, our Code mandates that we discharge our professional responsibilities with competence and diligence. Due care further includes that we adequately plan and supervise our performance of professional services. Finally, the Code requires that we obtain sufficient relevant data to afford a reasonable basis for conclusions or recommendations in relation to any professional services performed.

In summary, the requirements of competence and due care require that we exercise the care that a person in a like position would exercise under similar circumstances. That requires that we accept engagements that we have the competence to handle or reasonably believe that we can acquire the skills or retain the consultants to handle competently. This is especially important where a CIRA is asked to conduct a solvency analysis under the Bankruptcy Code where certain asset or liability classes require technical skills or experience to value or determine, respectively, that most CIRAs would not have. Furthermore, these requirements insist that we continue to participate in meaningful continuing education. In difficult financial times, many of us cut back our budget on CPE programs. That is short-sighted. Our professional world is changing dramatically and at warp speed. We must improve both the breadth and depth of our skills. Now is not the time to cut educational corners.

In my next column, I plan to address the remaining etihcs requirements.



Taxation Cases

Forrest Lewis
Plante & Moran PLLC

BASIS STEP UP REORGANIZATIONS IN BANKRUPTCY

One tool in the restructuring adviser's toolkit when a business is reorganized in Chapter 11 is a taxable transaction to transfer the business assets to the creditors with a stepped up tax basis in appropriate situations. The creditors end up owning the emerging entity with assets which have a fair market value basis which is then eligible for increased depreciation tax deductions as a way of preserving the favorable tax attributes of the debtor. Such reorganizations are often referred to as a "Bruno's transaction" after the arrangement used in the Plan of Reorganization for Bruno's Supermarkets in the 1990s. The Internal Revenue Service has issued some private letter rulings approving these transactions (e.g. 200350016), but the future viability of this technique is unknown.

"Normal reorganization" vs. basis step up reorganization

The basis step up reorganization is in a sense the polar opposite of a "normal" reorganization. In the normal reorganization, a taxfree Type E recapitalization or Type G bankruptcy reorganization is often used, which result in the creditors emerging as owners of the business with "carryover basis" in the assets which usually means relatively low tax basis for depreciation. Though the debtor entity typically comes into Chapter 11 with a large amount of tax net operating loss carryforwards, those often are greatly reduced or go completely unused at emergence. Conversely, in a basis step up reorganization there is a taxable sale of the business assets at fair market value by the debtor to the creditors early in the process before debts have been discharged. This means that the gain on sale can be offset by the debtor's tax net operating loss carryforwards. The creditors form a new entity to buy the assets in exchange for their claims which means that they hold the assets with a fair market value which leads to substantial depreciation tax deductions in the future. Essentially, the debtor's old tax net operating losses are translated into increased depreciation tax deductions for the successor.

Conditions favoring a basis step up transaction

Before going into further detail about the mechanics of a step up, let's review the fairly limited circumstances in which a basis step up reorganization makes sense:

1.The creditors must want to continue the business and act together in concert. This is probably the most difficult requirement. Usually creditors want cash, not a continuing interest in the business, so it makes most sense where there is a relatively small number of creditors who are cooperative with each other, a potentially viable business and little available cash. Conflicts between the various classes of claimholders can be very hard to reconcile. (Some variations of the basis step up transaction only work for short term unsecured creditors which makes the appeal of such a transaction very remote. More on that later).

2.It has to be a hard asset oriented business—likely manufacturing, construction, distribution, equipment leasing, etc. In those industries assets are usually depreciated for tax purposes using accelerated methods over 5 or 7 years sometimes resulting in a tax net book value substantially below fair market value. So, an increase to fair market value and the resulting rapid tax depreciation is of value in those industries. In contrast, depreciation lives for office buildings, warehouses and apartment buildings are usually 27.5 to 39 years, meaning the present value of the tax deductions is very low.

3.The basis step up has to be more valuable than the debtor's net operating loss and credit carryforwards and current asset basis. In some cases, the debtor's net operating loss carryforwards are large enough so they can withstand the Section 108(b) reduction. (When indebtedness is discharged in bankruptcy, the cancellation of debt income is not taxable under IRC Section 108(a), but in the following year favorable tax attributes such as net operating losses, credits and asset basis must be reduced in a corresponding amount). If the debtor's initial net operating losses and other favorable tax attributes are large enough, even after they suffer the mandatory reduction by the amount of the cancellation of debt income, the remaining amount will be more valuable than the increased depreciation from the basis step up transaction. Careful calculation needs to be made.

How a basis step up transaction works

In the original form of the transaction, the creditors created a new corporation (Newco) which will ultimately hold the assets and operate the business. The debtor corporation sells a substantial amount of its business assets to the participating creditors in exchange for the creditors' claims equal in amount to the value of the assets. Assuming there are multiple participating creditors, for transactional efficiency the debtor may either sell all of the assets to a creditor representative or nominee empowered to act on behalf of all of the participating creditors, or it may sell undivided interests in all of the assets to each of the participating creditors. The creditors (or their representative) then contribute the assets to Newco in exchange for additional shares of its stock.

The primary concern is to avoid accidental characterization by the IRS as a nontaxable Type G reorganization which would result in carryover basis for the depreciable assets. The defining characteristic of a Type G reorganization is "a transfer by a corporation of all or part of its assets to another corporation in a title 11 or similar case; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies [as a nontaxable reorganization of two corporations (Sec. 354) or a spin off in which a corporation conducting two active businesses distributes stock in one of them to the shareholders (Sec. 355)…."

Various methods have been used to intentionally fail the Section 354 or 355 tests and assure taxable sale treatment:

In the IRS ruling referenced above, the creditors taking part were all short term unsecured creditors who are by definition not "security" holders in the debtor. That resulted in no Newco stock going to old debtor security or stock holders, in other words failing the basic Type G definition.

In some transactions, substantial nonoperating assets such as office real estate are left in the debtor entity and leased to Newco or other parties. This is a failed Sec. 355 spin-off which puts this transaction outside of Type G.

In the so called "Grandparent" structure, a three tier holding company arrangement is used for Newco. Only stock of the top level tier is issued to the creditors in exchange for their claims on the debtor assets which go into the bottom tier operating company. Because of a technical quirk in the reorganization rules, this also is a failed taxfree reorganization under Sec. 354 which thus avoids falling into Type G status.

Conclusion

There is some debate whether IRS will continue to permit basis step up reorganizations or attempt to regulate them out of existence. [I for one do not see any abusive aspect as there is a taxable sale on one side and a basis step up which takes years to realize on the other—a very ordinary transaction under current tax policy--FL.] Probably there are fairly few cases out there where the basis step up transaction will work. While it is pretty common that the debtor's net operating losses will be completely eliminated by the discharge of debtor's liabilities, the other needed circumstances are less prevalent. In an appropriate case, the adviser will want to structure the transaction to maximize depreciable tax basis to the emerging company and avoid any risk of the transaction being recharacterized as a Type G reorganization which would result in carryover (low) basis. ■

Thanks to Grant Newton and Dennis Bean for their assistance with this article and to Carl Pickerill of Chicago for his insights.

BANKRUPTCY ESTATE'S INTEREST IN NOL—TIME TO RETHINK?

Today there are numerous cases involving corporate groups filing federal consolidated tax returns in which some subsidiaries are in bankruptcy and some are not. Quite often in those groups the debtor corporations in bankruptcy have tax net operating losses and other subsidiaries have taxable income which can be offset by those net operating losses (NOLs). In past years, bankruptcy trustees carrying out their duty to search for assets which might be distributed to creditors often sought for the debtor corporation to be compensated for use of its net operating losses by other group members. Some courts required compensation to be paid under various legal theories but changes in IRS regulations in the last five years call into question the equitability of those theories.

In the best known case in this area, In re Prudential Lines, Inc., 928 F.2d 565 (2d Cir. 1991), the court held that unused losses of a bankrupt subsidiary were property of the bankruptcy estate and upheld an injunction preventing the parent from taking a worthless stock deduction. The ownership of tax refunds and the right to use tax attributes are state property law issues, not tax issues. Federal tax laws specify how refunds are paid and how and when tax attributes are used, but they are not dispositive as to the ownership of these economic benefits. Under Treas. Reg. § 1.1502-77(a), the common parent is the agent for the consolidated group in most matters, including paying Federal income tax and receiving tax refunds, and no subsidiary has the authority to act for itself in any matter, with limited exceptions. Under consolidated return Regulation 1.1502-21, net operating losses are computed initially at the subsidiary level, applied as a "consolidated net operating loss" of the whole group and then any remaining NOL is allocated back to the subsidiary level. This complicates the ownership question the courts must deal with.

Some corporate groups have "tax sharing agreements" which are contractual arrangements which require subsidiaries generating taxable income to compensate loss subsidiaries for use of their tax net operating losses. Certainly where these exist, a trustee has a sound basis for seeking compensation to the estate/debtor corporation. However, true contractual arrangements are sometimes confused with "tax allocation rules" to which all corporate groups are subject under IRC Section 1552 which merely affect tax basis and certain other tax calculations and do not provide the real world hard receivable which trustees seek. (See related article in this column in the August/September, 2008 issue)

Another factor of federal tax law is the many "anti-trafficking in NOL rules" such as the separate return limitation of Regulation 1.1502-21 and IRC Section 382 which serve to limit or eliminate net operating losses acquired when there is an ownership change of a corporation with NOLs. These rules make the NOLs of the debtor subsidiary of no practical value to anyone outside existing corporate group. The rules of IRC Section 108(b) which require reduction of NOL carryforwards subsequent to a nontaxable discharge of indebtedness set a short life span, usually a year or two, for the usefulness of the NOLs even to the debtor corporation. As we will see later, these rules have been greatly expanded in recent years and are the reason for this article.

Cases favorable to the trustee

While most courts have held that the NOL had no value to the estate, some courts have found that NOLs do have value and to the extent that NOLs of the debtor are used, the trustee is justified in demanding compensation to the estate for that use. Some of the theories are:

Taxation continues from **Page 5**

- Equity
- Unjust enrichment
- Breach of fiduciary duty (the parent is merely the agent to get the refund for the debtor)

However, most of these decisions were reached prior to 2005 in an era where there was only upside for the consolidated group in using NOLs of a debtor member.

The "fan out rules"

The IRS had wrestled for years with whether every single tax item should be computed at the consolidated level. After its loss in United Dominion, 2001-1 U.S.T.C. ¶50,430 in which the US Supreme Court upheld an implicit consolidated product liability loss and substantial refunds to the taxpayer, the IRS promulgated Regulation 1.1502-28(a)(4). That provision says that the price to be paid for the discharge of the bankrupt subsidiary's debts is not limited to reducing the NOLs of the debtor, but would apply to all members of a corporate group. For cases after March 22, 2005, where there is a debt discharge which is treated as nontaxable because the debtor is in a federal bankruptcy case or because of insolvency, favorable tax attribute carryforwards are to be reduced in the following (somewhat simplified) order:

- Net operating losses and credit carryforwards of the debtor subsidiary
- Tax basis of the assets of the debtor subsidiary (but not below the amount of any remaining indebtedness)
- Net operating losses of other members of the consolidated group. (There is no reduction to basis of other members).

The amount of reduction is limited to the amount of indebtedness discharged.

Example: Parent has filed a consolidated tax return for five years with its subsidiaries Loser Company and Marginal Company. Loser had net operating loss carryforwards of $10 million, debts of $15 million and assets of $1 million. Marginal had net operating losses of $6 million but did not file a petition in bankruptcy. Parent was merely a holding company and had no financial activity. In Year 6, Loser was reorganized under Chapter 11 and $14 million of debt was discharged. As of the beginning of Year 7, Loser's $10 million of NOLs were reduced to zero. (The basis of Loser's assets were not reduced as assets equaled remaining liabilities.) Marginal's net operating loss carryforward of $6 million was also reduced by $4 million ($14 million - $10 million = $4 million) under the "fan out rules" despite the fact it had not filed a petition in bankruptcy and none of its debts were discharged.

Conclusion

The "fan out rules" have become a major problem in bankruptcies involving consolidated tax groups where not all corporations have filed a petition. Subsequent to 2005, the equities are no longer so favorable to the debtor/estate subsidiary which has NOLs which can be used by other members. While the group may initially enjoy use of debtor's net operating loss, debtor's debt discharge may come around to significantly bite the group later. A debtor entity may have a fairly small amount of net operating loss carryforwards itself, but the discharge of its debts may cause a fan out that could create a reduction of a much greater amount in NOLs of the other group members not involved in the bankruptcy case. Certainly the amount of? NOLs of other members of the group at risk must now be "subtracted" in determining any value of the NOLs of the debtor. ■

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

INDIVIDUAL: IRS SAYS TIMELY FILED TAX RETURN REQUIRED FOR DISCHARGE

In BAPCPA 2005, the Congress inserted a little known provision in the Bankruptcy Code section which authorizes discharge of "old and cold" taxes which IRS has interpreted to mean that the underlying tax return must be timely filed in order to be discharged. As most of you know, the relevant tests of dischargeability of income taxes contain three prongs:

(1) the date a tax return for the period was last due (including extension) was more than three years prior to the date of the bankruptcy filing (Bankruptcy Code §§ 523(a)(1)(A) and 507(a)(8)(A)(i));

(2) no new assessments of tax for the period have been made in the 240 days preceding the filing (Bankruptcy Code §§ 523(a)(1)(A) and 507(a)(8)(A)(ii));

(3) a return was filed for the applicable period more than two years prior to the filing (Bankruptcy Code §§ 523(a)(1)(B)(i) and (ii));

When the IRS catches a nonfiler they sometimes just prepare a tax return for the individual per Internal Revenue Code Section 6020. If the taxpayer cooperates and signs the return it falls under Section 6020(a). If the taxpayer won't sign it, the IRS goes ahead and processes the return anyway under Section 6020(b) and proceeds to try to collect the tax. Before BAPCPA 2005 there was a controversy as to whether an IRS-prepared return which the taxpayer signs could be discharged. In Section 714 of the 2005 Act, the Congress wisely clarified that an IRS-prepared return which the taxpayer signs does qualify for discharge, if it meets the timing rules above. (They also clarified that a tax return which the taxpayer still refuses to sign and is processed under 6020(b) does not qualify for discharge).

Here is the exact wording that was added as an unnumbered paragraph at the end of BC Section 523(a):

> For purposes of this subsection, the term "return" means a return that satisfies the requirements of applicable nonbankruptcy law (including applicable filing requirements). Such term includes a return prepared pursuant to

section 6020(a) of the Internal Revenue Code of 1986, or similar State or local law, or a written stipulation to a judgment or a final order entered by a nonbankruptcy tribunal, but does not include a return made pursuant to section 6020(b) of the Internal Revenue Code of 1986, or a similar State or local law.

The problem arises from the parenthetical "(including applicable filing requirements)". IRS has argued successfully in two post-2005 bankruptcy court cases that the parenthetical language means the return has to be timely filed [In Re: Jeffrey Links docket no. 08-3178 (Bankr. N.D. Ohio), In re Creekmore, 401 B.R. 748 (Bankr. N.D. Miss. 2008)]. In the Jeffrey Links case, he filed his 2002 federal income tax return on April 18, 2004, more than six months after his last extension expired and filed a bankruptcy petition in Chapter 7on April 30, 2007. The Court ruled that despite the fact that the 2002 return was filed more than three years before the petition in bankruptcy, the 2002 taxes could not be discharged because the return was not timely filed.

Analysis

here is no mention in the Congressional Committee Report on BAPCPA Section 714 of what is meant by "including applicable filing requirements". It may be just one of those things that slips through unnoticed as large, comprehensive legislation is passed. In fairness to the IRS position, it is hard to envision any other meaning than the return has to be in proper form and timely filed. However, their harsh interpretation frustrates another stated Congressional policy, that is to encourage taxpayers to file voluntarily. Interestingly, the Court said in the Links case that a taxpayer could still get a discharge for returns prepared by the IRS and signed by the taxpayer under IRC Sec. 6020(a) and that's what a delinquent taxpayer should do.

Editorial comment

So, the result of the Court's view is that a delinquent taxpayer who tries to do the right thing and prepares and files a return on his own informing the IRS of his tax liability cannot get a discharge. But if he goes to IRS and gets them to prepare a return for him and signs that, he can get a discharge. The Links court's reconciliation of this is not practical as rare would be the person who was several years delinquent on his taxes, walks into an IRS office to initiate their preparation of a return computing tax which he did not intend to pay, go through the pain of dealing with IRS Collections division for at least 240 days and then file a petition in bankruptcy only to get the returns older than three years discharged. In the meantime he would have delivered himself into the hands of the IRS for the most recent three years which presumably had not been filed either. Stay tuned as there are bound to be more developments on this issue. ■

Thanks to Dennis Bean, CPA and Jeffrey Gilman, Esq. for bringing this issue to light.

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

Forrest Lewis, CPA is a tax practitioner based in East Lansing, Michigan.

Bankruptcy Cases

Baxter Dunaway

SEVENTH CIRCUIT

Can an asset purchase be recharacterized as a "leveraged buyout" ("LBO"), and be avoided as a fraudulent transfer, when the acquired entity is left with unreasonably small assets after the transaction?

The Seventh Circuit held that an asset purchase may be recharacterized as a "leveraged buyout" ("LBO"), and may be avoided as a fraudulent transfer under § 544(b) and the Uniform Fraudulent Transfer Act, when the acquired entity is left with unreasonably small assets after the transaction. Boyer v. Crown Stock Distribution, Inc., 587 F.3d 787, 52 Bankr. Ct.Dec. 101, Bankr. L. Rep. P 81,628 (7th Cir.(Ind.) Nov 18, 2009).

Chapter 7 trustee filed adversary complaint, seeking to recover, as fraudulent transfers under Indiana law, transfers totaling $3.3 million that debtor had made to now-inoperative manufacturing company for the purchase of the company's assets, and an additional $590,328.00 "dividend" that company distributed to its shareholders around the time of the sale. The United States Bankruptcy Court entered an order avoiding the transaction as fraudulent as to the $3.3 million payments, but ruled that the "dividend" was legitimate. Defendants appealed, and trustee filed cross-appeal. The District Court, affirmed, and appeals were taken.

The Seventh Circuit Court of Appeals, Posner, Circuit Judge, held that:

(1) the parties' transaction was a leveraged buyout (LBO);

(2) the bankruptcy court did not clearly err in finding that debtor's payments were made without receiving "reasonably equivalent value" under Indiana's Uniform Fraudulent Transfer Act (UFTA);

(3) the "dividend" was part of the fraudulent transfer, not a normal distribution of previously earned profits; and

(4) trustee was entitled to recover from shareholders, as initial transferees, the payments of $3.3 million as well as the $590,328.00 "dividend." Affirmed in part, reversed in part, and remanded.

The court recharacterized the asset purchase as a leveraged buyout:

> An LBO can take the form of an asset acquisition ... . The purchase was nominally of the assets of [Oldco], but actually of the ownership of the company; for [Oldco] distributed the money it received in the sale forthwith to its shareholders and from then on existed only as a shell. [Newco] operated under

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> the same name as its predecessor, and its trade creditors and other unsecured creditors were not even told about the transaction. That reticence would be normal if the stock of a corporation were sold, rather than its assets; but in a sale of its assets, the seller's creditors would expect to be notified that they would henceforth be dealing with a different firm. 587 F.3d 787, 793-4.

The new company had unreasonably small assets:

> But new Crown started life almost with no assets at all, for all its physical assets were encumbered twice over, and the dividend plus new Crown's interest obligations drained the company of virtually all its cash. It was naked to any financial storms that might assail it. So the statutory condition for a fraudulent conveyance was satisfied-or so at least the bankruptcy judge could and did find without committing a clear error. 587 F.3d 787, 795.

The defendant argued that the new company survived for three years, but the court rejected this argument:

> The interval was longer than in previous cases, but the defendants are unable to sketch a plausible narrative in which new Crown could have survived indefinitely despite being cash starved as a result of the terms of the LBO that brought it into being. The fact that Smith made mistakes in running the company does not weigh as strongly as the defendants think. Everyone makes mistakes. That's one reason why businesses need adequate capital to have a good chance of surviving in the Darwinian jungle that we call the market. 587 F.3d 787, 795.

As for the $500,000 "dividend" the court noted it was an integral part of the LBO, although the trustee stumbled by failing to present evidence concerning old Crown's dividend policy. Family-owned companies rarely pay dividends, but instead channel profits into salary in order to avoid double taxation. 587 F.3d 787, 795.

Research References: Dunaway, The Law of Distressed Real Estate, Ch. 23. Law of Fraudulent Transfers, XII. Leveraged Buyout As a Fraudulent Conveyance, § § 23:34.to 23.37 (Westlaw LAWDRE); Bankruptcy Service, L. Ed. §§ 31:257, 31:299, 31:305, 31:306; Norton Bankr. L. & Prac. 3d § 63:7, 68:8, 68:10, 68:11, 68:13 to 68:16; Norton Bankr. L. & Prac. 3d 11 U.S.C. § 544 Bankruptcy Law Manual 5d §§ 8:3, 8:26; West's Key Number Digest, Bankruptcy 2641, 2645 to 2646.

THIRD CIRCUIT

Are "settlement payments" made by or to a financial institution protected from avoidance by 11 U.S.C.A. § 546(e)?

The Third Circuit reaffirms its holding in Resorts International that "settlement payments" made by or to a financial institution are protected from avoidance by 11 U.S.C.A. § 546(e). In re Plassein Intern. Corp., 590 F.3d 252 (3rd Cir.(Del.) Dec 22, 2009).

Chapter 7 trustee in the bankruptcy proceedings of debtor and the subsidiaries it had acquired prepetition in related leveraged buyouts filed adversary complaint against shareholders of acquired corporations, seeking to avoid the buyout payments made to shareholders for their privately-held stock as fraudulent transfers under state law and the Bankruptcy Code. Shareholders moved to dismiss. The United States Bankruptcy Court granted dismissal motions, and trustee appealed. The District Court affirmed. Trustee appealed. The Court of Appeals held that debtor's buyout payments to shareholders of acquired corporations were "settlement payments" protected from avoidance by 11 U.S.C.A. § 546(e), even though the securities in question were privately-held as opposed to publicly-traded. Affirmed.

Plassein was formed in 1999 to acquire several privately-held manufacturing corporations through leveraged buyouts. In a leveraged buyout, the purchaser funds the acquisition using borrowed money with the target company's assets usually being pledged as security for the loan after the acquisition is completed.

As planned, Plassein acquired several manufacturing corporations through leveraged buyouts in which, in accordance with an agreement with Plassein's lenders, each newly-acquired corporation pledged its assets as collateral for the loans to Plassein to finance the purchases. Furthermore, each acquired corporation agreed that it would be jointly and severally liable for all the funds that Plassein borrowed for all of the leveraged buyouts. As would be expected, this cross pledging of assets and assumptions of liability resulted in each acquired company having debts far exceeding its assets and thus, according to the trustee, the transactions rendered the acquired corporations insolvent.

In the settlement system, a third-party clearing agency acts as an intermediary between an anonymous buyer and seller. The clearing agency, however, is more than just a conduit because it guarantees to the buyer and seller that the transaction will settle as agreed, an event normally occurring a few days after the trade is booked. This guarantee inspires confidence in the trading system and permits lightning-fast trading but it also subjects the clearing agency to possible liability if the transaction does not settle as agreed. For their part, the buyer and seller guarantee that they will deliver the money and securities as promised, even though they may be waiting to receive that property from some other party.

The Court noted that they do not write on a blank slate when construing section 546(e) which shields certain settlement payments from a trustee's power to avoid a transfer as fraudulent. In Lowenschuss v. Resorts Int'l, Inc. (In re Resorts Int'l, Inc.), 181 F.3d 505, 509 (3d Cir.1999) (" Resorts "), as a result of the Court's analysis of section 546(e), the Court concluded that the challenged transfer could not be avoided as a fraudulent transfer. Other Courts of Appeals have followed the opinion in Resorts. See, e.g., QSI Holdings, Inc. v. Alford (In re QSI Holdings, Inc.), 571 F.3d 545, 551 (6th Cir.2009); Contemporary

Indus. Corp. v. Frost, 564 F.3d 981, 985-86 (8th Cir.2009); see also Lisa G. Beckerman & Robert J. Stark, LBOs and Fraudulent Conveyances: The Third Circuit Does an About Face, 2 Norton Bankr.L. Adviser 1 (2000) (noting the "watershed" ruling). 590 F.3d 252, 256.

FIFTH CIRCUIT

Do damages under § 362(k) include attorney's fees and expenses incurred by a debtor in prosecuting an adversary proceeding to recover damages for a willful violation of the stay?

Failing to agree with the Fifth Circuit, the Ninth Circuit rules that damages under § 362(k) do not include attorney's fees and expenses incurred by a debtor in prosecuting an adversary proceeding to recover damages for a willful violation of the stay. Sternberg v. Johnston, 582 F.3d 1114 (9th Cir. 2009), as amended, (Oct. 22, 2009). Chapter 11 debtor's actual damages from attorney's violation of automatic stay that arose upon debtor's filing petition for bankruptcy protection entitled debtor to recovery of attorney fees only for work associated with enforcing the automatic stay and remedying stay violation, but not fees incurred in prosecuting bankruptcy adversary proceeding in which debtor pursued his claim for those damages. 11 U.S.C.A. § 362(k)(1).

The filing of a bankruptcy petition immediately gives rise to an automatic stay. The stay applies to block or freeze most judicial actions against a debtor. It also permits a debtor to recoup any "actual damages," including attorney fees, that result from a willful stay violation. See11 U.S.C. § 362. This case presents the question as to what attorney fees may be recovered as "actual damages." In interpreting "actual damages," a phrase not defined in the statute, the court relied primarily on the phrase's plain meaning, defined as an amount awarded to compensate for a "proven injury or loss." Using this definition, the court held that the "proven injury" in this case was the injury that resulted from the stay violation itself. Once the violation had ended, any fees debtor incurred in seeking a damage award were not "actual damages" under § 362(k)(1). In this way, attorney's fees incurred in preventing violations of the automatic stay were included as part of the "proven injury" to be remedied, but fees incurred in litigating the adversary proceeding were not.

The Ninth Circuit recognized that the Fifth Circuit appears to have held to the contrary: "The lower courts in our Circuit have concluded that it is proper to award attorney's fees that were incurred prosecuting a section 362(k) claim [,]" and "[w]e adopt the same reading of section 362(k) and therefore agree." Young v. Repine (In re Repine), 536 F.3d 512, 522 (5th Cir.2008). The Court noted they do not create a circuit split lightly. But the above-quoted language is all the Fifth Circuit said on the issue. Without more, the Ninth Circuit were hard-pressed to find this decision persuasive.

NINTH CIRCUIT

Is debtor's acquisition of ownership interest in property outside 1,215-day period protected as a homestead from exemption cap?

Ninth Circuit holds that the § 522(p) monetary limit on homestead exemption does not apply to property to which a debtor acquired title more than 1,215 days before debtor filed a bankruptcy petition, even if debtor did not live there until a few days before filing. In re Greene, 583 F.3d 614, Bankr. L. Rep. P 81,596, 09 Cal. Daily Op. Serv. 12,414, 2009 Daily Journal D.A.R. 14,427 (9th Cir.(Nev.) Oct 02, 2009).

Prior to the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "BAPCPA"), one of the most notorious abuses of the bankruptcy system involved the "financial planning" strategy by which debtors purchase expensive homes in states which allow an unlimited homestead exemption under 11 U.S.C.A. § 522(b)(2)(A), declare bankruptcy, and continue to enjoy a life of luxury while their creditors get little or nothing. The states vary widely in homestead exemptions. Some states have no cap and others very low caps. The Act did not place an absolute cap on the value of the exemption, but some changes were enacted. Section 522(p) of the Bankruptcy Code imposes an aggregate monetary limitation of $125,000, subject to Bankruptcy Code §§ 544 and 548, on the value of property that the debtor may claim as exempt under state or local law pursuant to § 522(b)(3)(A) under certain circumstances. The monetary cap applies if the debtor acquired such property within the 1,215-day period preceding the filing of the petition and the property consists of any of the following: (1) real or personal property of the debtor or that a dependent of the debtor uses as a residence; (2) an interest in a cooperative that owns property, which the debtor or the debtor's dependent uses as a residence; (3) a burial plot for the debtor or the debtor's dependent; or (4) real or personal property that the debtor or dependent of the debtor claims as a homestead.[1]

Although Chapter 7 debtor placed recreational vehicle and tent on his non-residential property and converted property into homestead within 1,215 days prior to filing petition for bankruptcy, debtor's perfection of homestead exemption, under Nevada law, did not qualify for monetary cap on "any amount of interest that was acquired" during 1,215-day period, within meaning of Bankruptcy Code capping provision, and thus, debtor's acquisition of ownership interest outside of 1,215-day period protected his homestead exemption claiming market value of $240,000 from monetary cap that would have limited his exemption to $125,000.[2]

SECOND CIRCUIT

Under the Bankruptcy Code, is an unsecured creditor entitled to recover post-petition attorneys' fees that were authorized by a pre-petition contract but were contingent on post-petition events?

The Second Circuit held that an unsecured claim for postpetition attorney's fees authorized by a prepetition contract is allowable under § 502(b) and is deemed to have arisen prepetition. The protections afforded

1 See, Dunaway, The Law of Distressed Real Estate, § 28A:56.1.Exemptions—Homestead exemption—Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (Westlaw LAWDRE).

2 11 U.S.C.A. § 522(d), (p)(1); West's NRSA 115.005, 115.020.

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over-secured creditors under § 506(b) do not implicate unsecured claims for postpetition attorney's fees and therefore present no bar to recovery. Ogle v. Fidelity & Deposit Co., 586 F.3d 143 (2d Cir. 2009).

Pursuant to Agreements, Fidelity provided surety bonds to Agway's insurers, and Agway in turn agreed to indemnify Fidelity for any payments that it made under the Bonds as well as legal fees incurred to enforce the Agreements. On October 1, 2002, Agway filed a voluntary Chapter 11 bankruptcy petition. Up until then, Agway had not defaulted on any payment obligation to its insurers; Fidelity's claim in bankruptcy therefore asserted no more than a contingent right to payment under the Agreements.

When Agway thereafter defaulted on payments to its insurers, the insurers in turn sought payment from Fidelity, and Fidelity tendered payment consistent with its obligations under the Bonds. Fidelity incurred additional costs, including legal fees, enforcing its indemnity rights against Agway in prolonged litigation. On July 18, 2008, the Bankruptcy Court concluded (as relevant here) that Agway was liable for Fidelity's post-petition attorneys' fees.

The parties thereafter settled all of the issues between them except the order requiring payment of post-petition attorneys' fees. Ogle appealed that part of the bankruptcy court's order to the district court pursuant to 28 U.S.C. § 158(a), and the district court affirmed the bankruptcy court's order. Ogle appealed to the Second Circuit court.

Courts are closely divided on the question presented. One line of cases holds that an unsecured claim for post-petition attorneys' fees asserted on the basis of a prepetition contract is allowable. See, e.g., In re SNTL Corp., 571 F.3d 826, 839-45 (9th Cir.2009) (" SNTL "); Martin v. Bank of Germantown, 761 F.2d 1163, 1168 (6th Cir.1985). Another line of cases holds that such a claim is disallowed. See, e.g., Adams v. Zimmerman, 73 F.3d 1164, 1177 (1st Cir.1996); Waterman, Ditto, 248 B.R. 567, 573 (8th Cir. BAP 2000).

Section 502(b)(1) bars any claim that "is unenforceable against the debtor and property of the debtor, under any agreement or applicable law for a reason other than because such claim is contingent or unmatured." 11 U.S.C. § 502(b)(1). Travelers[3] construed this wording to mean that "any defense to a claim that is available outside of the bankruptcy context is also available in bankruptcy." 549 U.S. at 450, 127 S.Ct. 1199. Unless a claim is unenforceable under state law or one of the section 502(b)(2)-(9) exceptions applies, courts must "presume" that the claim "will be allowed in bankruptcy unless [it is] expressly disallowed." Id. at 452, 127 S.Ct. 1199.

In the present appeal, as in Travelers: The underlying contract is valid as a matter of state substantive law; none of the section 502(b)(2)-(9) exceptions apply; and the Code is silent as to the particular question presented- in Travelers, whether the Code allows "unsecured claims for contractual attorney's fees incurred while litigating issues of bankruptcy law," 549 U.S. at 453, 127 S.Ct. 1199; and here, whether the Code allows unsecured claims for "fees incurred while litigating issues of" contract law more generally.

Accordingly, the Court held that an unsecured claim for post-petition fees, authorized by a valid pre-petition contract, is allowable under section 502(b) and is deemed to have arisen pre-petition.

Research References: Norton Bankr. L. & Prac. 3d §§ 48:32, 52:12

THIRD CIRCUIT

Does the Rooker-Feldman doctrine preclude the Bankruptcy Court and the District Court courts from exercising jurisdiction over the debtor/ plaintiffs' state rescission claim?

The Third Circuit Court upheld the decisions of the Bankruptcy Court and the District Court that the Rooker-Feldman doctrine precluded those courts from exercising jurisdiction over the Madera plaintiffs' rescission claim, because "that claim was inextricably intertwined with the [state court] foreclosure judgment." Madera v. Ameriquest Mortgage Co. (In re Madera), 586 F.3d 228, 232 (3d Cir.2009).

The Rooker-Feldman doctrine precludes lower federal courts "from exercising appellate jurisdiction over final state-court judgments" because such appellate jurisdiction rests solely with the United States Supreme Court. See Lance v. Dennis, 546 U.S. 459, 463, 126 S.Ct. 1198, 163 L.Ed.2d 1059 (2006). The Ninth Circuit has held that this doctrine applies equally to federal bankruptcy courts. See In re Knapper, 407 F.3d 573, 582 (3d Cir.2005).

The Rooker-Feldman doctrine is implicated when, "in order to grant the federal plaintiff the relief sought, the federal court must determine that the state court judgment was erroneously entered or must take action that would render that judgment ineffectual." FOCUS v. Allegheny County Court of Common Pleas, 75 F.3d 834, 840 (3d Cir.1996). Accordingly, a claim is barred by Rooker-Feldman under two circumstances: (1) "if the federal claim was actually litigated in state court prior to the filing of the federal action" or (2) "if the federal claim in inextricably intertwined with the state court adjudication, meaning that federal relief can only be predicated upon a conviction that the state court was wrong." In re Knapper, 407 F.3d at 580.

Moreover, a federal claim is "inextricably intertwined" with an issue adjudicated by a state court when (1) the federal court must determine that the state court judgment was erroneously entered in order to grant the requested relief, or (2) the federal court must take an action that would negate the state court's judgment. Id. at 581 (quoting Walker v. Horn, 385 F.3d 321, 330 (3d Cir.2004)).

In Madera, a mortgage foreclosure default judgment was entered in state court against the plaintiffs. Thereafter, one of the Madera plaintiffs filed a chapter 13 petition in bankruptcy court and the plaintiffs instituted an adversary proceeding against the mortgagee, asserting that the mortgagee had

3 Travelers Casualty & Surety Co. of America v. Pacific Gas & Electric Co., 549 U.S. 443, 127 S.Ct. 1199, 167 L.Ed.2d 178 (2007).

failed to accurately disclose the terms of the mortgage loan under the Truth in Lending Act, 15 U.S.C. § 1601 et seq., ("TILA"). Based on TILA, the Madera plaintiffs sought rescission of the mortgage loan, as well as damages. Madera, 586 F.3d at 230-31.

The Third Circuit Court upheld the decisions of the Bankruptcy Court and the District Court that the Rooker-Feldman doctrine precluded those courts from exercising jurisdiction over the Madera plaintiffs' rescission claim, because "that claim was inextricably intertwined with the [state court] foreclosure judgment ." Id. at 232. The Bankruptcy and District Courts determined that granting rescission would negate the foreclosure judgment. Id. The Third Circuit agreed, determining that "a favorable decision for the Maderas in the federal courts would prevent the Court of Common Pleas from enforcing its order to foreclose the mortgage." Id. See also Faust v. Deutsche Bank Nat'l Trust Co. (In re Faust), 353 B.R. 94, 100 (Bankr.E.D.Pa.2006) (holding that the bankruptcy court lacked jurisdiction under the Rooker-Feldman doctrine to hear a rescission claim brought under the Pennsylvania Unfair Trade Practices and Consumer Protection Law after entry of a judgment in a state court mortgage foreclosure action, because "rescinding the loan would negate the state court judgment.")

Research References: Dunaway, Law of Distressed Real Estate § 28:10.13. Preclusion in bankruptcy and the Rooker-Feldman Doctrine—Statutory preclusion of jurisdiction.(Westlaw: LAWDRE 28:10.13).

ELEVENTH CIRCUIT

Does the "continuing concealment" doctrine protect creditors objecting to discharge under § 727(a)(2)(A) when a debtor keeps assets out of a creditor's reach during the one-year look-back period?

In In re Coady, Coady v. D.A.N. Joint Venture III, L.P. (In re Coady) 588 F.3d 1312 (11th Cir. Dec. 3, 2009), debtor-husband filed a voluntary bankruptcy petition under Chapter 7. A creditor initiated an adversary proceeding to contest the discharge under 11 U.S.C.A. § 727(a)(2)(A). After a trial, the bankruptcy court entered a judgment sustaining the objection and denying discharge. The district court affirmed the bankruptcy court's orders. On appeal, the Eleventh Circuit affirmed. The Eleventh Circuit held that the continuing concealment doctrine protects creditors objecting to discharge under § 727(a)(2)(A) when a debtor keeps assets out of a creditor's reach during the one-year look-back period.

This case arises from creditor D.A.N.'s attempts to recover as the assignee of a 1991 judgment for $290,000 entered against Coady in Connecticut. Coady had formerly been a successful real estate developer with a net worth of approximately $10 million, but an economic downturn left him $27 million in debt. While so indebted, Coady married, moved into his wife's house, drove a car leased in her name, and for over ten years worked exclusively as an "uncompensated independent contractor" for business entities under her sole ownership. He drew no salary, but his wife allowed him to write checks in her name on the businesses' accounts to pay personal expenses. She also paid for his country club and golf club memberships, the latter of which he used to promote a golf consulting and marketing business that she owned. Although Coady had neither income nor an individual bank account, in 1999 he personally executed a $164,000 promissory note to fund a real estate development for one of the businesses.

Section 727(a)(2)(A) of the Bankruptcy Code, provides:

The court shall grant the debtor a discharge, unless-...

> (2) the debtor, with intent to hinder, delay, or defraud a creditor or an officer of the estate charged with custody of property under this title, has transferred, removed, destroyed, mutilated, or concealed, or has permitted to be transferred, removed, destroyed, mutilated, or concealed-
>
> > (A) property of the debtor, within one year before the date of the filing of the petition....

The Court of Appeals held that debtor's equitable interest in his wife's businesses, acquired through arrangement in which he diverted fruits of his labor to increase value of his wife's businesses, could constitute "property of the debtor" within scope of 11 U.S.C.A. § 727(a)(2)(A) provision denying discharge for concealing assets from creditors within one year before date of filing of bankruptcy petition. Regardless of whether creditor had already learned of debtor's equitable interests in his wife's businesses before one-year look-back period, debtor's arrangement with his wife could amount to "concealment" of assets during look-back period, as required to support denial of discharge. ■

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interests that are "materially adverse" under Rule 2014, "all connections" that are not so remote as to be <u>deminimis</u> must be disclosed. Id. 175 B.R. at 536. The disclosures must be explicit and complete. Coy or incomplete disclosures which leave the Court to ferret out pertinent information from other sources are not sufficient. See In Re Granite Sheet Metal Workers, Inc., 159 B.R. 840, 845.

<u>Reasonable and Normal Business Terms</u>

Courts will examine whether the proposed application and retention of a professional is reasonable under the circumstances and will examine the reasonableness of proposed compensation for a professional. Although professionals may note what is common in the "market-place", some Courts that have taken the approach that compensation and employment arrangements are "market driven" not "market-determined," especially in the realm of bankruptcy where the Courts play a special supervisory role. See United Artists Theatre Co. The Walton 315 F.3d 217, 230 (3d Cir. 2003).

Courts must determine the reasonableness of compensation "based on (i) the nature of the services, (ii) the extent of the services, (iii) the value of the services, (iv) the time spent on the services, and (v) the cost of comparable services in non-bankruptcy cases." In re Busy Beaver Blvd. Ctrs., 19 F.3d 833, 840 (3d Cir. 1994). The Court, on its own initiative, may "award compensation that is less than the amount of compensation that is requested." 11 U.S.C. § 330(a)(2).

Section 328(a) of the Code, provides for retention of professionals on the basis of, among other things, fixed fees that are approved upon their retention, but subject to revisiting at the conclusion of the case on the basis that the fee approved up front was "improvident in light of developments not capable of being anticipated at the time of the fixing of such terms and conditions." Section 328(a) thus authorizes:

§ 328 Of the Code (a) provides:

> (a) The trustee, or a committee appointed under section 1102 of this title, with the court's approval, may employ or authorize the employment of a professional person under section 327 or 1103 of this title, as the case may be, on any reasonable terms and conditions of employment, including on a retainer, on an hourly basis, on a fixed or percentage fee basis, or on a contingent fee basis. Notwithstanding such terms and conditions, the court may allow compensation different from the compensation provided under such terms and conditions after the conclusion of such employment, if such terms and conditions prove to have been improvident in light of developments not capable of being anticipated at the time of the fixing of such terms and conditions.

Unless a professional's retention application unambiguously specifies that it seeks approval under Code section 328, the professional's fees are reviewable for reasonableness under Code section 330. As a matter of good practice, the retention order should specify that retention has been approved pursuant to Code section 328 to avoid any ambiguity. See Circle K Corp. v. Hamilton, Lokey, Howard & Zukin, Inc. 279 F.3d 669 (9th Cir. 2001). Cert. Denied. 536 U.S. 950 (2002). The mere fact that a committee seeks to employ a professional on an hourly basis does not preclude a bankruptcy court from evaluating the reasonableness of other terms and conditions of employment. Code section 328(a) authorizes the imposition of caps on fees that a professional may charge, even if the committee, trustee, or debtor submitted an application and did not propose that limitation. See In re Federal Mogul-Global, Inc. 348 F.3d 390(3d Cir. 2003).

Since the standard for departing from a fee award in a pre-approved amount under section 328(a) is very difficult to satisfy, the pre-approval of a large fee request must not be taken lightly. See Committee of Equity Sec. Holders of Federal-Mogul Corp. v. Official Comm. Of Unsecured Creditors (in re Federal Mogul-Global Inc.), 348 F.3d 390, 397 (3d Cir. 2003); In re XO Communications, Inc., 323 B.R. 330,339 (Bankr. S.D.N.Y. 2005) ("Under section 328(a), a court may not revisit its prior determination as to the reasonableness of an agreement previously approved unless it determines that the terms and conditions proved to be improvident at the time approved in light of then unforeseen circumstances.").

The Court, "has an obligation to determine the reasonableness of terms and conditions before authorizing the employment of professionals under § 328(a) and may eliminate, modify, or impose additional terms and conditions to satisfy the requirement of reasonableness." In re High Voltage Engineering Corp., 311 B.R. 320, 333 (Bankr. D. Mass. 2004). An applicant seeking employment under § 328(a), "must establish that the terms and conditions of employment are reasonable, and evidence, not conclusory statements, is required to satisfy that burden." Id.

Courts have examined section 328(a) retentions under a non-exclusive list of factors to be considered, including: "(1) whether terms of an engagement agreement reflect normal business terms in the marketplace; (2) the relationship between the debtor and the professionals, i.e., whether the parties involved are sophisticated business entities with equal bargaining power who engage in an arms-length negotiation; (3) whether the retention, as proposed, is in the best interests of the estate; (4) whether there is creditor opposition to the retention and retainer provisions; and (5) whether, given the size, circumstances and posture of the case, the amount of the retainer provisions; including whether the retainer provides the appropriate level of "risk minimization," especially in light of the existence of any other "risk-minimizing" devices, such as an administrative order and/or a carve-out". In re Insilco Techs., Inc., 291 B.R. 628, 633 (Bankr. D. Del. 2003). "this list is not intended to be exhaustive, nor will every factor necessarily be of equal weight, depending upon the circumstances." Id. at 634.

However, for professionals seeking to be compensated under § 328, the court must make an initial determination of the benefit that the professionals' services will provide the estate. This is essential because once the bankruptcy court has determined that the terms and conditions of a professional's retention application are reasonable, under § 328(a), it may thereafter reduce that compensation only if it determines that "such terms and conditions prove to have been improvident in light of developments not capable of being anticipated at the time of the fixing of such terms and conditions." In re Federal Mogul-Global Inc., 348 F.3d 390, 397 (3d Cir. 2003). For this reason, § 328 applications require particularly close scrutiny at the outset because the money paid to those professionals will be even more difficult, if not impossible to disgorge once distributed. See In re XO Communications, Inc., 323 B.R. 330, 339 (Bankr. S.D.N.Y. 2005).

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Avant Advisory Group

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FTI Consulting Inc

Johnny Lee
Grant Thornton LLP

Stephen Perrella
Zolfo Cooper

Kyle Sturgeon
Alvarez & Marsal LLC

Erik Toth
FTI Consulting Inc

Andrew Domescik
Navigant Capital Advisors

Brett Frederick
Castle Megastore Group, Inc.

Gregory Hagood
Navigant Capital Advisors, LLC

Michael Lane
Navigant Capital Advisors LLC

Peter Mosley
Alvarez & Marsal LLC

Alan Mustacchi
Navigant Capital Advisors

Peter Rubsam
Dempsey Partners LLC

Stanley Seat
Stanley F. Seat, PC

Mary Dressler
Navigant Capital Advisors, LLC

James Shepherd
Navigant Consulting Inc

David Swanson
FTI Consulting Inc

Colin Wittmer
PricewaterhouseCoopers LLP

CLUB 10

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

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Alvarez & Marsal LLC	**65**	**Huron Consulting Group LLC**	**19**
AlixPartners, LLP	**59**	**BDO Seidman LLP**	**16**
KPMG LLP	**34**	**CRG Partners Group LLC**	**16**
Zolfo Cooper	**32**	**Mesirow Financial Consulting LLC**	**16**
Deloitte.	**28**	**PricewaterhouseCoopers LLP**	**13**
Grant Thornton LLP	**27**	**Protiviti Inc**	**13**
Navigant Capital Advisors LLC	**21**	**DLC Inc.**	**12**
LECG LLC	**20**	**J H Cohn LLP**	**10**

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