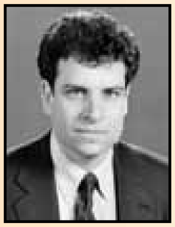
AIRA Association of Insolvency & Restructuring Advisors™

Journal

News from the Association of Insolvency & Restructuring Advisors

Volume 24, Number 6 – February/March 2011



Marc Rosenberg
Kaye Scholer LLP

Madlyn Primoff
Kaye Scholer LLP

Iain Kennedy
Kaye Scholer LLP

ALSO IN THIS ISSUE

In re DBSD North America, Inc.: Second Circuit Addresses Trio of Issues

On February 7, 2011, the United States Court of Appeals for the Second Circuit issued a significant decision that addresses a trio of important bankruptcy-related issues in *In re DBSD North America, Inc.*[1] First, the Court held that a chapter 11 plan that included a "gift" by secured creditors of part of their recovery to a junior class of equity holders over the objection of a dissenting class of unsecured creditors violated the absolute priority rule and was thus unconfirmable. Second, the Court "designated" (disregarded) a secured creditor's vote to reject a chapter 11 plan on good faith grounds. The secured creditor was a competitor of the debtor that had purchased claims in an effort to control the bankruptcy process and ultimately to acquire the debtor. Finally, the Court held that an "out-of-the-money" creditor with a disputed and unliquidated claim had standing to appeal plan confirmation.

BACKGROUND

DBSD North America, Inc. ("DBSD") was founded in 2004 to provide hybrid satellite and terrestrial mobile communications. Despite launching a satellite and obtaining FCC spectrum licenses, the service never materialized, and DBSD had accumulated a large amount of debt and had little revenue to offset its obligations. As a result, on May 15, 2009, the company filed a chapter 11 petition, listing debts of $40 million owed under a first lien revolving credit facility and $650 million in second lien secured notes, in addition to various unsecured claims. Among the unsecured claims was a disputed and unliquidated claim held by Sprint Nextel Corporation ("Sprint") based upon an ongoing lawsuit against a DBSD subsidiary, which claim the bankruptcy court temporarily allowed for voting purposes in the amount of $2 million.

During the chapter 11 case, DBSD proposed a plan of reorganization that restructured the indebtedness of the first lien debt holders and provided that the second lien debt holders would receive the bulk of the equity in the reorganized entity, which equity was not sufficient to repay the second lien holders in full. Under the proposed plan, unsecured creditors would receive a very small amount of equity while existing equity holders (primarily DBSD's parent, ICO Global Communications) would receive equity interests and warrants in the reorganized enterprise as a "gift" from the undersecured second lien holders.

Shortly after DBSD filed its chapter 11 plan and related disclosure statement, DISH Network Corporation ("DISH"), which held a significant investment in a direct competitor of DBSD, purchased all of DBSD's first lien debt at its full face value of $40 million and $111 million of the second lien debt in order to control the bankruptcy process related to what DISH viewed as a "potentially strategic asset."

Sprint voted to reject the plan and objected to confirmation, asserting that the distribution to old equity violated the absolute priority rule of section 1129(b) of the Bankruptcy Code. Section 1129(b)(2)(B) provides that a plan is "fair and equitable" with respect to a dissenting impaired class of unsecured claims if the creditors in the class receive or retain property of a value equal to the allowed amount of their claims or, failing that, no creditor of lesser priority, or shareholder, receives "any property" under the plan "on account of such junior claim or interest." The bankruptcy court overruled Sprint's objections to the plan's confirmation, characterizing the equity holder's receipt of shares and warrants as a "gift" from the holders of the second lien debt who were senior to Sprint in priority and, yet, themselves not receiving the full value of their claims. The bankruptcy court concluded that such "gifting" did not violate the absolute priority rule. The Court held that it would permit gifting at least when there were understandable reasons for the gift from the secured creditors, no obvious ulterior motives, and the complaining creditor would recover nothing more if the gift were not made.

DISH similarly voted its claims against confirmation of the plan, and proposed to enter into a strategic transaction with DBSD. The bankruptcy court designated DISH's vote, rejecting the plan as not

***DBSD North America** continues on p. 4*

1 *In re DBSD North America, Inc.*, Nos. 10-1175, 10-1352, 2011 WL 350480 (2d Cir. Feb. 7, 2011).

CONTENTS

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

At AIRA's 27th Annual Conference in Boston over 100 industry experts will cover the latest in bankruptcy and restructuring in a wide range of topics and presentations. During the three and a half day event, there will also be many networking opportunities to meet with peers and make connections, old and new. There will be two noteworthy keynote presentations:

JAMES R. WIGAND, DIRECTOR, FDIC, OFFICE OF COMPLEX FINANCIAL INSTITUTIONS (CFI)

Mr. Wigand's dynamic and very timely discussion will focus on the CFI's responsibilities, including the review and oversight of bank holding companies, and the FDIC's new authority for the orderly liquidation of bank holding companies and nonbank financial companies.

CHARLIE BAKER, ENTREPRENEUR IN RESIDENCE AT GENERAL CATALYST PARTNERS

Former Secretary of Health and Human Services and Secretary of Administration and Finance under two Massachusetts governors, Mr. Baker left state government to become CEO of Harvard Vanguard Medical Associates and was recruited shortly thereafter by its parent company, Harvard Pilgrim Health Care (HPHC). He was the 2009 Republican candidate for governor of Massachusetts.

BOSTON

From its lovely sailboat-dotted harbor to quaint historic neighborhoods to panoramic skyline scenes, Boston is an exciting destination city where business and pleasure are a natural combination. Although it is a contemporary center of finance and technology, the site of Paul Revere's midnight ride and the Boston Tea Party beckons visitors to experience 18th century steeples, Beacon Hill (the best of America's exquisite neighborhoods) and the famous 2.5 mile pedestrian Freedom Trail. Historic treasures abound: King's Chapel, site of the Boston Massacre, Paul Revere's home, The Granary Burying Ground, the Quincy Market, the Old Corner Bookstore, the USS Constitution, and Bunker Hill Monument. AIRA's Annual Conference program includes an exciting selection from Boston's many cultural, recreational and geographic opportunities.

CONFERENCE HOTEL

InterContinental Boston
510 Atlantic Avenue
Boston, MA 02210
Front Desk: +1-617-7471000
Fax: +1-617-2175190

Rooms available at $225
Group Code: E4N

REGISTER ONLINE AT

www.AIRA.org

Emerging from Bankruptcy – A Tactical Approach to Fresh Start Accounting

Daniel Gary, CIRA
KPMG

Brian Heckler
KPMG

Recently, there have been numerous prominent Chapter 11 filings, including those of Dana, Delphi, MCI/WorldCom, and United Airlines. Companies emerging from Chapter 11 bankruptcy proceedings are commonly required to apply what is known as "fresh start accounting." The term "fresh start" refers to resetting the fair values of a company's assets and liabilities to the fair values on the date the company emerges from bankruptcy. The result of a fresh start exercise is similar to purchase accounting for an acquired entity–all assets and liabilities are adjusted from historical balances to fair market values. Therefore, fresh start accounting has a significant and pervasive impact on the financial statements of companies as they emerge from bankruptcy.

Although bankruptcy is not an uncommon business occurrence, it is a one-time event in the life of a company. Organizations typically do not have personnel with prior fresh start accounting experience. Particular skills are required to gather data, perform valuation studies, research accounting issues, record adjustments, and draft financial statements. It is critical to design a plan that addresses key issues upfront in order to minimize disruption to the organization, including errors and delays.

UNRECORDED INTANGIBLES

Fresh start guidance requires all assets to be recorded at fair value–even assets that were not previously recorded. For some organizations, significant enterprise value stems from intangible assets that do not reside on the balance sheet. This is common for companies that were not acquisitive and, therefore, did not previously record acquired intangibles. Identifying and inventorying unrecorded intangibles can be a challenge, as companies may not have had a reason to track such assets. Locating personnel with knowledge of these assets and accumulating data for valuation studies requires lead time, coordination of resources, and combined knowledge of accounting guidance and valuation techniques.

For example, companies may have large patent portfolios containing both active and inactive patents. Valuing a patent under the income approach requires projected cash flows attributable to the patent. Most companies do not maintain records linking specific patents with product-level cash flow projections. Moreover, it would be impractical to manually perform this process for each patent in a portfolio of thousands. Therefore, it is important to identify the data requirements early in the process to not only allocate adequate resources, but also to consider alternative approaches. For example, it may be acceptable to join patents based on common characteristics and value the group's patents rather than each individual patent. In addition, IT personnel may be needed to automate the process by interfacing disparate systems.

Product or technology development projects may also have value, but may not be at a stage where capitalization of related costs is permitted by authoritative accounting guidance. Fresh start accounting requires that such projects, referred to as in-process research and development (IPR&D), be identified, valued, and expensed. The issues and challenges previously discussed with regard to patents are commonly applicable to IPR&D as well. For example, companies may not be tracking development projects and linking such projects to cash flow projections required for valuation studies.

CONVENIENCE DATE

Fresh start accounting is applied from the date a company emerges from bankruptcy, a date that is determined by the bankruptcy court. However, companies are generally permitted to utilize a convenience date–typically a more "convenient" financial reporting date, such as a month-end or quarter-end that is close to the emergence date. The following factors should be considered when selecting a convenience date for public filings:

Split period. Financial statements are required for the predecessor period (before the emergence date) and the successor period (afterwards). Therefore, if the emergence date occurs within a quarter, the financial statements are required for both periods within that quarter–meaning two sets of financial statements are required, instead of one.

Filing deadlines. Using the first day of a quarter as the convenience date provides maximum time to determine fair values, record adjustments, and draft financial statements. Companies typically have a very short window to complete these tasks (125 days maximum, assuming a 90-day quarter with a 35-day accelerated filing deadline).

Performing a preliminary dry run of valuation and fresh start accounting enables a company to identify pitfalls before the 125-day window begins. Financial and tax accountants can identify issues, support their positions, and proactively clear issues with their external auditors or regulators. Moreover, the duplication of efforts for performing both a dry run and a final valuation can be minimal. For example, valuation resources can build models and research market price comparables for the dry run, then

Tasks to be Completed Within 125 Days

- Identify and inventory each significant asset and liability
- Gather a robust data set for the valuation studies
- Perform valuation studies
- Record fair value adjustments
- Draft financial statements and disclosures reflecting the new fair value basis
- Explain the new basis of your financial statements (disclosures, MD&A)

Tactical Approach continues from p. 3

refresh the data used by those models as of the convenience date. This approach leaves more of the 125-day window for management to draft financial statements and perform analyses on the results of operations to ensure they convey a clear explanation to users of the financial statements.

RECORDKEEPING

Recordkeeping becomes an important consideration from the standpoint of timing and effort. There are benefits to recording the adjustments at the detailed asset record level–the financial information is subject to the internal controls of the accounting system and less manual effort is required. However, several factors may preclude recording the adjustments and drafting financial statements within the 125-day window, including a high volume of asset records, multiple or fragmented accounting systems, and inflexible legacy systems.

Therefore, it may be necessary to maintain top-side adjustments for a short time following the quarter of emergence in order to meet external reporting deadlines. Concurrently, a plan could be formulated to upload the adjusted fair values, design controls to maintain data integrity, and address internal control issues to maintain Sarbanes-Oxley 404 compliance.

System limitations are often identified during the recordkeeping stage. Legacy systems, certain ERP systems, and databases may not accommodate the new record layouts that are required to maintain both financial reporting and tax information. For example, certain systems permit only one field for cost. However, two cost fields may be needed–historical cost for tax purposes and new fair value for fresh start reporting. Recordkeeping and data requirements should not be underestimated, and IT and data management resources should be involved in the planning process.

CONCLUSION

Fresh start accounting has a significant and pervasive impact on a company's financial statements. A successful fresh start implementation requires planning and experience in order to identify challenges, pitfalls, and choices upfront in order to minimize disruption to the organization, chance of error, and delays of emergence. ■

DBSD North America continues from p. 1

having been cast in good faith under section 1126(e) of the Bankruptcy Code. The bankruptcy court found that DISH was voting against the plan not as a traditional creditor seeking to maximize its return on the debt it held, but rather to control the reorganized company and to obtain a competitive advantage.

After rejecting the objections of Sprint and DISH and designating DISH's vote, the bankruptcy court confirmed the plan. The district court affirmed the decision of the bankruptcy court and Sprint and DISH appealed to the Second Circuit.

SECOND CIRCUIT'S DECISION

Appellate Standing

As a threshold matter, the Second Circuit rejected DBSD's argument that an out-of-the-money creditor such as Sprint lacked standing to appeal plan confirmation. The Second Circuit held that a creditor has standing to appeal if it has a valid and impaired claim, regardless of whether the claimant is out-of-the-money based on the bankruptcy court's valuation of the debtor. Furthermore, the Court held that Sprint had standing by virtue of the fact that it had a chance of improving its position under an alternate plan through appeal. The Second Circuit reasoned that a restrictive rule on standing like the one proposed by DBSD would severely limit the classes of creditors who could appeal, eliminating their protection under the law.[2]

Absolute Priority Rule

With regard to the absolute priority rule, the Second Circuit reversed confirmation of the plan, holding that the plan violated the rule. The court held that the absolute priority rule prohibits the receipt by existing shareholders of any property under a plan on account of their prior interests, including property covered by a secured creditors' lien. The Court held that the gift to the existing shareholders came out of the DBSD estate, not from the collateral of the second lien debt holders, and thus violated the absolute priority rule.[3]The Court declined to address whether a gift made outside a plan may be permissible.

Vote Designation

Finally, the Second Circuit upheld the bankruptcy court's designation of DISH's vote to reject the plan, noting that although it is not *per se* improper for a secured creditor to vote in its own self-interest or to have ulterior motives in voting on a plan, certain motives rise to the level of lacking good faith. The Court based its ruling upon certain key factual findings of the bankruptcy court, including the price DISH paid for the claims (par value), the late timing of DISH's purchase (after DBSD had filed its plan), DISH's status as a competitor of the debtor, and DISH's stated intention as reflected in its own internal communications to "control the bankruptcy process for this potentially strategic asset." The Court held that although some ulterior motives outside the treatment of its claims are appropriate, such as a trade creditor's desire to continue to transact business with the debtor, designation is proper if a creditor attempts to vote its position to obtain a benefit to which it is not entitled.[4]

2 Circuit Judge Pooler dissented on the appellate standing issue, arguing that Sprint should be denied standing to appeal confirmation because its unliquidated claim was contingent upon a successful outcome in underlying litigation that was far from guaranteed. In response, the majority stated that standing cannot depend upon the merits of the underlying claim because such a requirement would place an untenable burden on the appellate court to evaluate the merits of each claim before granting standing. Also, the bankruptcy court had temporarily allowed Sprint's claim for voting purposes.

3 The Court distinguished *In re SPM Manufacturing Corp., Inc.*, 984 F.2d 1305 (1st Cir. 1993), an oft-cited First Circuit decision permitting a gift from secured creditors to equity holders, as SPM involved a chapter 7 case where the absolute priority rule does not apply. Also, the Court noted that the "gift" in SPM Manufacturing was made by the secured creditors after the court had granted relief from the automatic stay and treated the "gifted" property as no longer property of the debtor's estate.

4 *Significantly, the Court not only affirmed the bankruptcy court's decision to designate the vote of the sole first lien creditor, DISH, but it also affirmed the bankruptcy court's decision to disregard the entire class of first lien debt for*

CONCLUSION

The Second Circuit's ruling will limit the traditional role gifts have played in facilitating consensual chapter 11 plans in cases filed in the Southern District of New York. In many chapter 11 cases, senior creditors have agreed to make a gift to equityholders in order to obtain old equity's cooperation and support for a consensual plan. Although the Court declined to address whether gifts made outside of a plan are proper under the Bankruptcy Code, senior creditors considering post-confirmation gifts will need to tread carefully in light of the disclosure, good faith and other legal issues potentially implicated by such an approach. Of course, consensual gifts are still permissible after *DBSD* and junior creditors, even junior creditors that are not being paid in full, may prefer a "gift" to old equity rather than being mired in a protracted chapter 11 case.

With regard to vote designation, the Court's decision appears to rest on the premise that an ulterior motive outside of maximizing the pure cash recovery on a claim may be permissible, but an improper motive, such as a competitor purchasing a blocking position in a class of claims and voting that position out of its strategic interests, will lead a court to designate the plan votes. The Court reserved judgment on whether the same result would obtain in the case of a preexisting creditor. However, the Court declined to elaborate on what actions by secondary purchasers of bankruptcy claims will cross the fine line between acceptable practice and improper motive. Given the fact-specific nature of any designation determination, would-be acquirers of chapter 11 debtors will need to fully consider the *DBSD* decision.■

purposes of determining whether the class of first lien claimants had accepted the plan under section 1129(a)(8) of the Bankruptcy Code. As a result, the debtor's plan did not need to satisfy the cramdown requirements with respect to the class of first lien debt.

Executive Directors Column

Grant Newton, CIRA

2011 ANNUAL CONFERENCE IN BOSTON

You will not want to miss AIRA's27th Annual Conference held at the InterContinental in Boston, June 8-11. The opening presentation will feature Charlie Baker, Republican candidate for governor of Massachusetts in 2009. Mr. Baker currently serves as the Entrepreneur in Residence at General Catalyst Partners in Cambridge, MA, focusing on investing in small and mid-size firms, primarily in the health care services industries.

Charlie has spent the past twenty years serving in senior leadership positions in the public and private sectors. In the 1990s, he served as Secretary of Health and Human Services and Secretary of Administration and Finance under Massachusetts Governors Bill Weld and Paul Cellucci. Charlie left state government to become the CEO of Harvard Vanguard Medical Associates in 1998, and was recruited shortly after that by the Board of its parent company, Harvard Pilgrim Health Care (HPHC). As president of HPHC, he was successful in rescuing it from the brink of insolvency and restoring it to profitability.

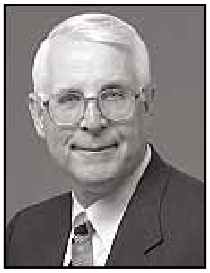
James R. Wigand, recently appointed Director of the FDIC's Office of Complex Financial Institutions (CFI), will be the Friday Luncheon speaker. Prior to this position, Mr. Wigand served as the Deputy Director for Franchise and Asset Marketing in the Division of Resolutions and Receiverships (DRR), directing the sale of over 300 deposit franchises and over $600 billion in failed bank and thrift assets since 1997. Jim has served in various executive positions at the FDIC and Resolution Trust Corporation (RTC).

Mr. Wigand will address some of the issues raised by the following questions:

- Will the Dodd-Frank Act create an incentive for banks to recognize nonperforming assets on a more timely basis? If so, how?
- How will the Dodd-Frank Act impact hedge funds and will disclosure requirements limit hedge funds from playing an activist role in restructurings through buying positions in distressed companies in the secondary market?
- What impact will Dodd-Frank and the ongoing evolution of the bank regulatory framework- either positively or negatively – have on the hedge fund industry? Will non-banks face greater hurdles in providing liquidity to distressed companies?
- To what extent do you think larger hedge funds are concerned about—rightfully or not—about being designated as Tier One Financial Services Companies by the FSOC? How could such designations impact the credit markets?
- In developing guidelines dealing with losses experienced by the receivership or bridge institution, will the priority (from bankruptcy or other sources) of creditors be respected?
- If FIFI's are global institutions, what type of cross-country sharing arrangements are being considered?
- Regarding "retention risk" two key issues, who has the retention risk (underwriter/investor? And is it in each tranche or just in the equity?
- Regarding the Office of Financial Research, what is the nature of the concept and what it is expected to do?
- What changes are expected in terms of deposit insurance, including assessments
- What changes re expected in accounting for financial subsidiaries and swaps?

I look forward to seeing you in Boston.

Grant



Bankruptcy Taxes

Forrest Lewis
Plante & Moran PLLC

COURT UPHOLDS BANKRUPTCY EXEMPTION FOR DISQUALIFIED RETIREMENT PLAN

Previously the Fifth Circuit had upheld a case in which a bankruptcy court disqualified a formerly qualified profit sharing plan and stripped it of its exemption, making it part of the bankruptcy estate (Plunk v. Yaquinto (In re Plunk), 5th Cir., No. 06-10426, 3/12/07). Now an Indiana bankruptcy court takes the opposite position, holding that even if the qualified plan committed prohibited transactions that should lead to its disqualification, the ERISA bankruptcy exemption still applied to keep the assets out of the bankruptcy estate (In re Hemmer, U.S. B.C., S.D. Indiana, 2011-1 U.S.T.C. ¶50,153, (Jan. 14, 2011)).

After leaving employment with Hallmark, Gregory Hemmer, started his own business, KDKR, Inc, a Nevada corporation. KDKR was in the business of selling fitness franchises. In early October 2005, KDKR established a profit sharing plan known as the KDKR, Inc. Profit Sharing Plan & Trust with Hemmer and his spouse as trustees. Hemmer rolled his entire pension proceeds (nearly $440,000) from his previous job into the Plan. As of May, 2006, Hemmer was the sole participant in the Plan. The Plan owned 39,000 shares of KDKR stock and Hemmer owned 100. Between 2005 and 2008, some of the Hemmers'living expenses were paid from Plan funds and some of the Plan funds were used to start fitness franchises. During that same period, KDKR made minimal or no revenue. Presumably the many prohibited transactions committed by the plan were never reported to IRS because in September , 2009, it issued a favorable determination letter that the Plan was tax-qualified under §401 of the Internal Revenue Code. When Hemmer filed his chapter 7 case on October 23, 2009, the balance of his interest in the Plan was $66,824.00.

Highlights of the Court's ruling: "ERISA provides for the uniform national treatment of pension plans.... Because it is a source of retirement income, ERISA requires that a plan contain anti-alienation and anti-assignment clauses, i.e. provisions that prohibit a participant from pledging his plan interest and likewise prohibit a creditor from garnishing it…. Section §401 of the Internal Revenue Code also requires a plan to contain anti-alienation features for it to be "tax qualified"....Section 541(c)(2) of the bankruptcy code removes from the expansive definition of "property of the estate"…a transfer of a beneficial interest of the debtor in a trust that is enforceable under "applicable nonbankruptcy law". ERISA is "applicable nonbankruptcy law" where the anti-alienation provisions required for ERISA plans constitute enforceable restrictions on transfers of interests. Thus, a debtor's interest in an ERISA plan is excluded from property of the debtor's bankruptcy estate under 11 U.S.C.A. §541(c)(2). Patterson v Shumate, 504 U.S. 753, 112 S.Ct. 2242, (1992).

There is no dispute that, at least as of September, 2009, the Plan was an ERISA plan, given the favorable determination letter from the IRS which indicated that the Plan was tax-qualified under §401 of the IRC. (The Plan could not have been determined to be tax qualified had it not contained an anti-alienation clause). The Trustee's sole argument for turnover is that the Debtor's use of Plan funds for personal living and business expenses as well as KDKR's lack of revenue (e.g. KDKR engaging in more of a "hobby" than a bonafide "business") invalidates the Plan's tax-qualified and ERISA status. Consequently, if the Plan is no longer tax qualified, then it is not an ERISA plan, and if the Plan is no longer an ERISA plan, the Shumate protection afforded to the Debtor 's interest in it disappears.

Tax qualification and ERISA qualification are separate and distinct features of a plan and "an ERISA plan that is not or may not be tax qualified nevertheless continues to be governed by ERISA for essentially every other purpose", In re Sewell, 180 F.3d 707, 711 (5 Cir. 1999). A plan trustee can violate his fiduciary duties as trustee and the still invoke Shumate to shield his interest in the plan. In re Baker, 114 F.3d 636, 640 (7th Cir. 1997)".

Conclusion: Since the Plunk and Hemmer decisions are pretty much diametrically opposed, it may require a ruling by the higher courts to resolve the controversy. Because the Plunk decision is a Court of Appeals decision and Hemmer is just a bankruptcy court decision, it may be that Hemmer will be overturned if appealed up the line. ■

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

INDIVIDUAL: IRS SAYS OVERPAYMENT CREDITED TO FOLLOWING YEAR NOT PROPERTY OF ESTATE

The Internal Revenue Service consistently takes the position that if a debtor with an individual income tax overpayment from one year elects to credit it toward to the tax for the following year, the overpayment cannot be reached for inclusion in the property of a Chapter 7 bankruptcy estate. Most recently, IRS affirmed that position in Letter Ruling 201103020.

Facts cited in the ruling: John and Jane Smith filed Form 1040 for tax year 2008 on March 10, 2009, reporting a $2,000 overpayment. The Smiths requested a refund of $1,200 and elected to apply the remaining $800 to their tax liability for 2009. The IRS mailed a refund of $1,200 to the Smiths on March 20, 2009, and applied the $800 to the 2009 tax year. Sometime after making the election to credit their 2008 overpayment to their 2009 taxes and after the deadline for filing their 2008 tax return had passed, the Smiths filed a voluntary petition for Chapter 7 bankruptcy. The Trustee requested that the $800 be turned over to him pursuant to 11 U.S.C. § 542.

Analysis in the ruling: "If the debtor had the right to claim a tax refund, the right to claim a refund and to bring a refund suit, if necessary, became property of the estate. Such a refund claim would be a debt owed to the debtor and should be paid to a Chapter 7 trustee under 11 U.S.C. § 542(b)…. In your example, however, the taxpayer elected to credit $800 of the overpayment to a future tax year. The overpayment for which a taxpayer made an I.R.C. § 6402(b) [crediting it forward] election is not subject to turnover request. If the debtor, having made the election, had no right to claim a refund when the bankruptcy petition was filed, there is no debt owing to the debtor for that tax year that would be subject to turnover under section 542."

Conclusion of the ruling: "The IRS is not required, under 11 U.S.C. § 542, to turn over to a Chapter 7 bankruptcy trustee an overpayment once a taxpayer's election, under I.R.C. § 6402(b), to credit the overpayment to future tax liabilities has become irrevocable."

Commentary: Some have noted that the IRS ruling only covers the fairly obvious case where the debtor made the election to credit forward before filing the bankruptcy petition. What about the case where the debtor credits an amount forward or makes an estimated tax payment before filing a petition when they do not expect any tax liability for the following year? Are these fraudulent conveyances? What about the case where the debtor makes the election to credit forward after filing the bankruptcy petition? This would seem to be an avoidable transfer, but getting the IRS to agree with that may be very difficult. ■

Thanks to Jay Crom for his insights and to Grant Newton and Dennis Bean for their assistance with this article.

COURT REFUSES IRS REQUEST TO BIFURCATE CLAIM

In a case of overreaching, a request by the IRS to bifurcate its bankruptcy claim between secured and unsecured after the fact was denied. The case involved J. H. Investment Services, Inc., a real estate investment company which turned out to be a real estate scam which operated for over ten years. Investors eventually discovered the true nature of JHIS and over 25 state court lawsuits were filed. In May of 2007 creditors initiated a Chapter 11 bankruptcy proceeding against JHIS and its former owner. The Bankruptcy Court appointed Steven S. Oscher as trustee and set December 1, 2009 as the deadline for creditors to file proofs of claim. In re J. H. Investment Services, Inc., U.S. District Court, M.D. Florida, Tampa Div.; 8:10-cv-1394-T-JSM, October 7, 2010, 2010-2 ustc ¶50,663.

The trustee was able to locate approximately 40 properties that he could potentially sell. Many of the properties were mortgaged. Working with creditors, he submitted a plan to the Bankruptcy Court to sell the properties at auction. Neither the trustee nor the IRS was ever entirely certain of what properties would be finally recovered given the nature of the fraud involved. For that reason, the IRS had difficulty determining what portion of its claim was secured and amended its claim several times. They ended up filing approximately a $46.8 million claim as a secured, priority claim.

However, there was so little equity in the secured properties that after some litigation, IRS settled the secured portion of its claim for under $150,000. IRS then filed a motion requesting the bankruptcy court to bifurcate the unsatisfied part of its claim into a priority, unsecured claim so that it could collect a small ($83,000) fund which had been set aside for unsecured claims. The Trustee objected and the bankruptcy court ruled that the IRS claim could not be bifurcated and would not participate in the unsecured set aside fund. The IRS appealed to the District Court.

The District Court stated:

"The IRS contends that it was not required to bifurcate its claim between secured and unsecured portions. It argues that, pursuant to 11 U.S.C. §506(a), its claim, by operation of law, becomes an unsecured claim to the extent that it exceeds the value of the collateral securing the claim. Its position is that the trustee is in a better position to know the value of the collateral, and the trustee and all other creditors should be aware that the IRS's claim will be an unsecured claim to the extent the collateral is not sufficient to satisfy it. 11 U.S.C. §506(a) provides, in pertinent part:

An allowed claim of a creditor secured by a lien on property in which the estate has an interest … is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property … and is an unsecured claim to the extent that the value of such creditor's interest … is less than the amount of such allowed claim.

The trustee argues that …it is not his job to determine what each creditor could claim, only to ascertain what they have claimed, and make appropriate provision in the plan. Rather, it is the creditor's responsibility to state what he is claiming and the trustee may object, if he disagrees with the claim, or accept it.

The trustee's position is the more compelling. … The filing of a proof of claim serves a due process function, it puts other parties in interest on notice of a claim. A proof of claim that is timely filed and not objected to by a party in interest is deemed allowed. 11 U.S.C. §502(a).…

The IRS's position of automatic bifurcation of a secured claim is not a new one. Indeed, the IRS has argued this position before and lost. In Re Envirocon International Corp. (98-1 ustc ¶50,103), 214 B.R. 251 (M.D. Fla. 1997). In In Re Envirocon International Corp., the Bankruptcy Court held that the IRS was not entitled to participate in the distribution of assets of a Chapter 7 estate because of its failure to move for valuation of its collateral after filing a proof of claim denominated only as a secured claim. The court affirmed the Bankruptcy Court and held that by characterizing the entire claim as secured, it forfeited any right to later participate as an unsecured creditor… See also In Re Padget, 119 B.R. 793 (Bankr. D. Col. 1990) (holding that an "undersecured creditor in a Chapter 7 case who files a claim denoted a secured claim must timely file an amended, or supplemental claim, for its unsecured claim-or give other legally sufficient notice of such claim to the trustee-if it desires to be treated as an unsecured creditor by the trustee"). ■

Thanks to Grant Newton and Dennis Bean for their assistance.

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

Bankruptcy Cases

Baxter Dunaway

Second Circuit

Can an inflated proof of claim filed by creditor in debtors' bankruptcy proceeding constitute a violation of Fair Debt Collection Practices Act (FDCPA)?

Second Circuit follows lower courts in holding that filing an inflated proof of claim in bankruptcy does not constitute a violation of the Fair Debt Collection Practices Act (FDCPA) § 803, 15 U.S.C.A. § 1692a. but award of attorney's fees and costs related to defendants' motion to dismiss was not warranted. *Simmons v. Roundup Funding, LLC*, 622 F.3d 93 (2nd Cir.(N.Y.) Oct 05, 2010) (NO. 09-4984-CV). Inflated proof of claim filed by creditor in debtors' bankruptcy proceeding could not form basis for claim under the FDCPA, since Bankruptcy Code provided exclusive remedy for attacking false or inflated proofs of claim. 11 U.S.C.A. §§ 105, 1330; Fair Debt Collection Practices Act, § 803, 15 U.S.C.A. § 1692a.

Research References:Bankruptcy Service, L. Ed. §§ 19:1609, 23:30, 23:31, 23:74, 23:395, 23:399, 53:304; Norton Bankr. L. & Prac. 3d 11 U.S.C. §§ 502, 503Bankruptcy Law Manual 5d § 6:4.

Supreme Court/Ninth Circuit

If the value of debtors' equity in home was not in excess of the homestead exemption when they filed bankruptcy, may the trustee still subsequently force a sale of the home to recover excess equity for the estate if the fair market value of the home appreciates postpetition?

The Ninth Circuit holds that if the value of Chapter 7 debtors' equity in their home was not in excess of the homestead exemption when they filed bankruptcy such that the trustee at the time had no obligation to object to the exemption, the trustee may still subsequently force a sale of the home to recover excess equity for the estate if the fair market value of the home appreciates postpetition. *In re Gebhart*, 621 F.3d 1206, Bankr. L. Rep. P 81,846, 10 Cal. Daily Op. Serv. 11,984, 2010 Daily Journal D.A.R. 14,475 (9th Cir.(Ariz.) Sep 14, 2010) (NO. 07-16769, 07-35704).

Generally, property of the estate is subject to the debtor's right to claim exemptions under Bankruptcy Code § 522. Sometimes the exemptions meet or exceed the fair market value of the property as of the petition date, allowing a debtor to claim the property as fully exempt unless an interested party objects. 11 U.S.C. § 522(*l*); Fed. R. Bankr.P. 4003(b)(1). Yet, even when a debtor claims property as fully exempt and there is no objection, the estate's interest in the property is not extinguished. *Schwab v. Reilly*, ---U.S. ----, 130 S.Ct. 2652, 177 L.Ed.2d 234 (2010); *accord In re Gebhart*, 621 F. 3d 1206, 2010 WL 3547641 (9th Cir. Sept. 14, 2010). Until the exempt property is sold by the trustee or abandoned from the estate, rather than the property itself, the Bankruptcy Code allows the debtor to maintain only an *interest in the property* up to the value of the claimed exemption. *Reilly*, 130 S.Ct. at 2662.

Reilly and its progeny clarify that a trustee need not object to the debtor's stated exemptions to preserve the right to later challenge the valuation of exempt property if the property is undervalued or appreciates while the bankruptcy case is pending. *Reilly* at 2660-61; *In* re *Gebhart*, 621 F. 3d 1206, 2010 WL 3547641, * 3 ("[e]ven when a debtor claims an exemption in an amount that is equal to the full value of the property as stated in the petition and the trustee fails to object, the asset itself remains in the estate ..."). In *Gebhart*, the Ninth Circuit Court of Appeals considered two consolidated appeals involving homes that were fully exempt on the petition date, but which later appreciated in value. 621 F. 3d 1206, 2010 WL 3547641, * 1. The debtors argued that because their homes were fully exempt on the petition date and the trustees did not object to the exemptions within the statutory time limit, the homes were withdrawn from the bankruptcy estates, and were owned by the debtors free and clear of the estate's interest. *Id.* Upon this belief, one debtor even refinanced his home with a lender who was apparently unaware the bankruptcy case was still open. *Id.* at *4. The court held that that the debtors' assertion of ownership was erroneous, and that the homes were not withdrawn from the bankruptcy estate merely because they were fully exempt and the trustees did not object to the exemptions. Rather, the court reiterated the principle that the homestead exemption operates to cap a debtor's interest in property at a certain dollar amount; it does not relinquish the full fair market value of the property to a debtor. *Id.*

Research References: Norton Bankr. L. & Prac. 3d § 56:10.

Supreme Court/Second Circuit

Are certain provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) that regulate "debt relief agencies" unconstitutional under the First Amendment and on due process grounds?

After briefing and oral argument in this appeal, the Supreme Court decided *Milavetz, Gallop & Milavetz, P.A. v. United States*, --- U.S. ----, 130 S.Ct. 1324, 176 L.Ed.2d 79, which resolved a number of the questions here at issue in *Connecticut Bar Ass'n v. U.S.*[1]. For a discussion of the *Milavetz* case, see the April/May 2010 AIRA Newsletter. In view of the *Milavetz* opinion, the Second Circuit in *Connecticut Bar Ass'n v. U.S.*[2] held that:

(1) attorneys providing bankruptcy assistance to consumer debtors qualify as "debt relief agencies" within the meaning of the BAPCPA; (2) neither law firm that represented only creditors nor attorney who did not represent debtors in bankruptcy had standing to pursue this case; (3) the BAPCPA's prohibition on advice to incur more debt in contemplation of bankruptcy is not unconstitutionally overbroad; (4) those provisions of the BAPCPA mandating certain disclosures were properly subjected to rational basis review, as specified in the Supreme Court's *Zauderer*[3] decision; (5) the BAPCPA provisions compelling debt relief agencies to provide certain written notices to their bankruptcy

1 Connecticut Bar Ass'n v. U.S., 620 F.3d 81, Bankr. L. Rep. P 81,842 (2nd Cir. (Conn.) Sep 07, 2010) (NO. 08-5901-CV (CON), 09-0015-CV (XAP)).

2 Connecticut Bar Ass'n v. U.S., 620 F.3d 81, Bankr. L. Rep. P 81,842 (2nd Cir. (Conn.) Sep 07, 2010) (NO. 08-5901-CV (CON), 09-0015-CV (XAP)).

3 471 U.S. 626, 105 S.Ct. 2265, 85 L.Ed.2d 652, 53 USLW 4587, 1985-2 Trade Cases P 66,645.

clients satisfy rational basis review; (6) the BAPCPA provisions compelling debt relief agencies to execute written contracts with their bankruptcy clients satisfy rational basis review; (7) the BAPCPA's advertising disclosure requirements satisfy rational basis review; and (8) the BAPCPA's contract requirements do not violate due process.

Affirmed in part, vacated and remanded with directions in part, and injunction dissolved.

References:

Validity, Construction, and Application of Provisions in Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) Regulating Debt Relief Agencies, 11 U.S.C.A. §§ 101(3), 101(4A), 101(12A), 526 to 528, 21 A.L.R. Fed. 2d 327.

Bankruptcy Law Manual s 3A:25, Representing the debtor--Debt relief agency--Restrictions on action (2010).

The 3-10-10 Bankers Letter of The Law, Act Regulation of Debt Relief Agencies (2010).

2010 Norton Bankruptcy Law Adviser 3, Recent Decisions from the Appellate Courts (2010).

Sixth Circuit

In a Chapter 13 case must the mortgage arrearage claim that must be cured under § 1322(e) include all fees and costs permitted by contract and applicable nonbankruptcy law even when creditor is undersecured pursuant to § 506(b)?

The Sixth Circuit held that a Chapter 13 debtor must include in the mortgage arrearage claim that must be cured under § 1322(e) all fees and costs permitted by contract and applicable nonbankruptcy law even when creditor is undersecured pursuant to § 506(b). *Deutsche Bank Nat. Trust Co. v. Tucker*, 621 F.3d 460, 64 Collier Bankr.Cas.2d 46, Bankr. L. Rep. P 81,847 (6th Cir.(Ky.) Sep 15, 2010) (NO. 09-5867).

The court noted that the decision turned on the interaction of two Bankruptcy Code provisions. Section 506(b) states that:

> [T]o the extent that an allowed secured claim is secured by property the value of which... is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement or State statute under which such claim arose.

Section 1322(e) provides that "[n]otwithstanding... section 506(b)... if it is proposed in a plan to cure a default, the amount necessary to cure the default [ ] shall be determined in accordance with the underlying agreement and applicable nonbankruptcy law." In this case, the Court stated that the language Congress used is unambiguous: Congress expressly resolved any potential conflict between section 1322(e) and section 506(b) in favor of section 1322(e):

> Notwithstanding ... section[ ] 506(b) ... of this title, if it is proposed in a plan to cure a default, the amount necessary to cure the default, shall be determined in accordance with the underlying agreement and applicable nonbankruptcy law.

When it comes to cure under section 1322(e), Congress says that section 506(b) is beside the point if the parties' agreement says otherwise. This obvious reading of the statute is not surprising virtually all of the courts to consider it have so held, including the Third Circuit and the Bankruptcy Appellate Panel for the Second Circuit. *See Key Bank of N.Y. v. Harko,* 211 B.R. 116, 122 (2nd Cir. BAP 1997); *Smiriglio v. Hudson United Bank*, 98 Fed.Appx. 914, 915-16 (3rd Cir.2004) (unpublished opinion); *see also In re Thompson,* 372 B.R. 860, 864 (Bankr.S.D.Ohio 2007) (collecting additional cases). *See* 2 Keith M. Lundin, Chapter 13 Bankruptcy, 3d Ed. 138-6 ("Ordinary canons of statutory construction would interpret the 'notwithstanding' in § 1322(e) to mean that § 1322(e) controls whether and to what extent fees, costs and other charges are allowed to cure default with respect to all mortgages entered into after October 22, 1994-including oversecured mortgages ...."); *id.* at 138-5.

Fifth Circuit

Did debtor's claim objection at earlier bankruptcy proceeding give creditor sufficient notice that its lien could be extinguished?

Fifth Circuit held that debtor's claim objection at earlier bankruptcy proceeding did not give creditor sufficient notice that its lien could be extinguished. In re Kleibrink, 621 F.3d 370 (5th Cir.(Tex.) Sep 21, 2010) (NO. 07-11190). In this bankruptcy appeal, debtor Ricky Kleibrink challenges the district court's affirmance of the bankruptcy court's ruling that creditor Mid State Trust VII holds an enforceable security interest in a property of his, despite his having received a discharge in an earlier bankruptcy proceeding. The debtor filed the instant bankruptcy proceeding in order to avoid the creditor's attempt to foreclose on the property. The bankruptcy court ruled that the earlier bankruptcy proceeding did not extinguish the creditor's lien against the property, because the claim objection filed by the debtor in the earlier proceeding did not afford the creditor due process in two ways. First, the claim objection was not accompanied by clear notice that the debtor was challenging the validity, priority, or extent of the lien, and that the debtor sought to abrogate the creditor's right to look to its collateral. Second, the debtor did not comply with the procedural safeguards set forth in Part VII of the Federal Rules of Bankruptcy Procedure. Accordingly, the bankruptcy court concluded that the claim objection filed by the debtor could not substitute for the adversary proceeding that is ordinarily required by the bankruptcy rules for extinguishing a lien under the circumstances of the case. The debtor appealed to the district court, which affirmed for substantially the same reasons.

In the time since the lower courts addressed the merits of this *Kleibrink* case, the Supreme Court issued its decision in *United Student Aid Funds, Inc. v. Espinosa,* --- U.S. ----, 130 S.Ct. 1367, 176 L.Ed.2d 158 (2010). *Espinosa* held that a judgment discharging debt in a bankruptcy proceeding is void under Rule 60(b)(4) where the creditor did not receive notice that satisfied the requirements of due process. *Id.* at 1378. " 'An elementary and fundamental requirement of due process in any proceeding which is to be accorded finality is notice reasonably calculated, under all the circumstances, to apprise interested parties of the pendency of the action and afford them an opportunity to present their objections.' " *Id.* at 1378 (quoting *Mullane v. Cent. Hanover Bank & Trust Co.,* 339 U.S. 306, 314, 70 S.Ct. 652, 94 L.Ed. 865 (1950)). Although the procedural posture of the instant case is different

Bankruptcy Cases *continues from p. 13*

from that of *Espinosa*, the dispositive issue is the same: whether a creditor in a bankruptcy proceeding received notice, satisfying the requirements of due process, that its interest could be extinguished in that proceeding. Accordingly, the Fifth Circuit affirmed the district court's judgment that the creditor's lien survived the earlier bankruptcy proceeding.

Seventh Circuit

Did a bankruptcy court abuse its discretion in rejecting proposed assignments to an investment trust of a Chapter 7 debtor's contracts to develop gas-to-energy conversion projects at landfill sites, on the ground that the trust had not given adequate assurance of future performance per 11 U.S.C. § 365(f)(2)(B)?

Seventh Circuit holds that bankruptcy court did not abuse its discretion in rejecting proposed assignments to an investment trust of a Chapter 7 debtor's contracts to develop gas-to-energy conversion projects at landfill sites, on the ground that the trust had not given adequate assurance of future performance. *In re Resource Technology Corp.*, 624 F.3d 376, Bankr. L. Rep. P 81,859 (7th Cir.(Ill.) Oct 01, 2010) (NO. 08-4118, 08-4310).

Section § 365 of the Bankruptcy Code allows the bankruptcy trustee to assume and assign a contract of the debtor to another party, but only if "adequate assurance of future performance by the assignee of such contract ... is provided." 11 U.S.C. § 365(f)(2)(B). "Adequate assurance of future performance" is interpreted by reference to section 2-609 of the Uniform Commercial Code. *Cinicola v. Scharffenberger*, 248 F.3d 110, 120 n. 10 (3d Cir.2001); *Richmond Leasing Co. v. Capital Bank, N.A.*, 762 F.2d 1303, 1310 (5th Cir.1985); *see also* Report of the Commission on Bankruptcy Laws of the United States, H.R. Doc. No. 93-137, pt. 2, at 156-57 (1973) (observing that the phrase "adequate assurance of future performance" "is adopted from Uniform Commercial Code § 2-609(1)"). Several factors are relevant to the determination: the financial ability to perform the contract; the general economic climate; the existence of a guarantee; the reputation of the party seeking to assume responsibility for the contract; and past dealings between the parties.

The Court held that the bankruptcy court did not abuse its discretion in rejecting proposed assumptions and assignments to investment trust of debtor's contracts to develop gas-to-energy conversion projects at landfill sites, on ground that trust had not given adequate assurance of future performance because it had not explained how it would obtain the $3 million necessary to perform debtor's obligations; trust had no independent assets or revenue stream, and was controlled by same managers who were at helm of debtor when it was forced into bankruptcy. 11 U.S.C.A. § 365(f)(2)(B). 624 F.3d 376, 384.

Seventh Circuit

Was there sufficient evidence to support the conviction of attorney for bankruptcy fraud and making false statements in bankruptcy petitions?

Bankruptcy attorney was convicted in a United States District Court of bankruptcy fraud and making false statements in bankruptcy petitions. He appealed. The Court of Appeals held that evidence was sufficient to support conviction. Affirmed. *U.S. v. Holstein*, 618 F.3d 610, Bankr. L. Rep. P 81,837 (7th Cir.(Ill.) Aug 18, 2010) (NO. 09-2822).

To establish Holstein's guilt for bankruptcy fraud, the government had to prove: (1) that he engaged in a fraudulent scheme; (2) that he made misrepresentations to the bankruptcy court; (3) in order to further the scheme. *See* 18 U.S.C. § 157 (2008). In order to prove Holstein guilty of falsifying documents before a bankruptcy court, the government had to show that he "falsified ... any document with the intent to impede, obstruct or influence" a bankruptcy matter. *See* 18 U.S.C. § 1519.

After a bench trial, Judge Grady found Holstein guilty beyond a reasonable doubt on all counts and sentenced him to one year and one day in prison. Specifically, the Judge found that Holstein solicited clients, accepted fees, and hid from the clients his impending suspension and consequent inability to complete the representation; misrepresented to the bankruptcy court that the debtors were unrepresented by counsel; and made the misrepresentations to conceal that he was practicing without a license.

Eighth Circuit Bankruptcy Appellate Panel

What are the elements of a case for revocation of a Chapter 7 discharge under § 727(d)(2)? The Eighth Circuit Bankruptcy Appellate Panel (" BAP") sets forth and applies the elements of a case for revocation of a Chapter 7 discharge under § 727(d)(2). In re Toftness, 439 B.R. 499 (8th Cir.BAP (Minn.) Nov 29, 2010) (NO. 10-6040). In this Chapter 7 case, the trustee brought this proceeding under 11 U.S.C. § 727(d)(2), which provides:

(d) On request of the trustee, a creditor, or the United States trustee, and after notice and a hearing, the court shall revoke a discharge granted under subsection (a) of this section if-

***

> (2) the debtor acquired property that is property of the estate, or became entitled to acquire property that would be property of the estate, and knowingly and fraudulently failed to report the acquisition of or entitlement to such property, or to deliver or surrender such property to the trustee[.]

Court of Appeals found that Bankruptcy court did not clearly err, in proceeding to revoke debtor's Chapter 7 discharge based on his failure to disclose or to turn over payments on promissory note that he received postpetition, in finding that debtor had acted with requisite fraudulent intent, given that payments were channeled through unscheduled limited liability companies of same name as corporation through which debtor had carried out business prepetition, and that debtor used payments to satisfy his personal needs. A debtor's intent may be inferred from all the surrounding circumstances where the debtor's pattern of conduct supports a finding of fraudulent intent. The focus is on whether the debtor's actions appear so inconsistent with his self-serving statement of intent that the proof leads the court to disbelieve the debtor. In an action to revoke a discharge, the plaintiff must prove each element by a preponderance of the evidence. 11 U.S.C.A. § 727(d)(2).

Eighth Circuit

Is there a conflict in appointment of a Chapter 11 trustee who also serves as receiver in a co-pending federal criminal receivership ?

Eighth Circuit finds no conflict in appointment of a Chapter 11 trustee who also serves as receiver in a co-pending federal criminal receivership. *Ritchie Special Credit Investments, Ltd. v. U.S. Trustee*, 620 F.3d 847, Bankr. L. Rep. P 81,845 (8th Cir. (Minn.) Sep 02, 2010) (NO. 09-3271).

Ninth Circuit

What is required for a bankruptcy court to have jurisdiction?

In *In re Ray*[4] The Ninth Circuit reviewed the requirements for bankruptcy court jurisdiction and held that the bankruptcy court lacked jurisdiction over this state law breach-of-contract claim.

After Chapter 11 debtor's plan had been confirmed and his case closed, would-be purchaser of a shopping center co-owned by debtor and his nondebtor business partner, which also had a right of first refusal for an undeveloped adjoining parcel that debtor and co-owner ultimately sold, with the bankruptcy court's approval, to a third party, brought state-court, breach-of-contract action against debtor, co-owner, and the third party, seeking, inter alia, specific performance of its first refusal rights. After reopening the case, the United States Bankruptcy Court for the Western District of Washington, determined that it had jurisdiction over purchaser's claims, granted summary judgment in favor of debtor and co-owner, and subsequently denied purchaser's motion to reconsider. Purchaser appealed. The Bankruptcy Appellate Panel (BAP) affirmed, and purchaser appealed.

Addressing issues of apparent first impression, the Ninth Circuit Court of Appeals held that:

(1) purchaser's claim for breach of contract neither "arose in" nor "arose under" the Bankruptcy Code;(2) purchaser's claim lacked a "close nexus" to the bankruptcy plan or proceeding and, thus, the bankruptcy court did not retain "related to" jurisdiction over it; and(3) the bankruptcy court lacked ancillary jurisdiction over the matter.Reversed and remanded with instructions. ■

Prof. Dunaway, Section Editor, is also Professor Emeritus at Pepperdine University School of Law.

4 In re *Ray*, 624 F.3d 1124, Bankr. L. Rep. P 81,873, 10 Cal. Daily Op. Serv. 13,501, 2010 Daily Journal D.A.R. 16,311 (9th Cir.(Wash.) Oct 25, 2010) (NO. 09-60005).

Bankruptcy Valuation: Selected Issues

Kenji Mochizuki, CIRA
Livingston Securities LLC

In the previous article of this section, the examination of deal dynamics to screen for better quality guideline transactions finished with an introduction to the motivations of buyers and sellers. The mergers and acquisitions (M&A) process often considers the buyer's viewpoint and the motives of the acquisition. Less frequently explored are the seller's viewpoint and the various motives of divestiture. Since the seller's sales price is an important baseline in the negotiation process that ultimately results in the actual purchase price, this article begins with a detailed discussion of both the seller's and buyer's viewpoints. Finally, several forms of statistical bias will be examined that could be considered when screening for guideline company transactions and selecting the comparable universe of guideline transactions.

MOTIVES OF DIVESTITURE[1,2]

A divestiture is the sale of an existing business or release/reduction of an asset by a firm. This may involve a company that subsequently divests a previous acquisition. There are many motives for a firm to divest a part of the company, including:

1. *To create or increase competition*–In 1984, divestiture was forced onto the Bell System under antitrust pressure from the U.S. Department of Justice to break up AT&T's local operations into seven Baby Bells. Shareholders were issued new shares in AT&T, which retained its long distance, manufacturing, and research divisions. As of the late 1990s, those shareholders also held stock in eleven new companies, including Ameritech, Bell Atlantic, BellSouth, Lucent Technologies, Nynex, Pacific Telesis, SBC Communications, Southwestern Bell, and US West as a result of this spin-off;

2. *To create stability*–In 2006, Philips Electronics N.V. divested its chip division called NXP, which represented only a very small part of Philips NV. However, the chip market was so volatile and unpredictable that NXP was responsible for the majority of Philips Electronics N.V.'s stock fluctuations.

3. *To create value*–A firm's break-up value might be believed to be greater than the value of the firm as a whole. The sum of a firm's individual asset liquidation values exceeds the market value of the firm's combined assets. This encourages firms to sell off what would be worth more when liquidated than when retained;

4. *To achieve a specific organizational form*–Managers can utilize certain types of divestitures, e.g. equity carve-outs or sell-offs (defined below), to alter the corporate organization structure by eliminating business units or creating new subsidiaries;

5. *To increase the firm's focus*–Businesses that are not part of its core operations are divested so that the firm can focus on what it does best, or implementing specific corporate strategy;

6. *To eliminate a low performing division or business*–Divestiture allows a firm to get rid of a division that is underperforming or even failing;

7. *To obtain funds*–By selling one of its businesses in exchange for cash, divestitures generate funds for the firm.

1 Introduction to Business, by Jeff Madura (South-Western College Pub, ©2006)

2 http://www.scribd.com/doc/6629503/Merger-Motives-and-Target-Valuation

Valuation continues from p. 15

TYPES OF DIVESTITURE[3,4]

There are several types of divestment, each representing different deal dynamics:

1. ***Asset trades***: Both companies involved in the transaction are buyers as well as sellers. Payment is in the form of barter, where each company's divestment is the other's acquisition. Sufficient transaction data may or may not be available for use in the guideline company transaction method

2. ***Subsidiary equity carve-out***: The parent firm creates a wholly-owned independent legal subsidiary, with stock and a management team that is different from the parent firm, and issues a portion of the subsidiary's stock to the public. Alternatively, a portion of the stock of an existing subsidiary could be sold to the public for the first time. Usually, only a minority share of the parent's ownership in the subsidiary is issued to the public. The cash raised may be retained in the subsidiary or transferred to the parent as a dividend, as a stock repurchase, or as an intercompany loan.

3. ***Partial equity (or partial divestiture)***: This creates a divestment by offering partial equity in its subsidiaries. For example, General Motors Corp. once offered two classes of stock shares: 1) Class A for its core automotive operations; and 2) Class H for its GM Hughes Electronics group. The company maintained a majority stake in Hughes, but allowed a minority of those shares to trade independently of General Motors Class A. At some point, if GM elected to divest most or all of its interest in Hughes, for example, it could merely sell its shares in that company to a buyer or to the general population of shareholders. The exchange would be made between GM and the buyer on the basis of money for shares. A partial divestiture differs from an equity carve-out because no new subsidiary is created with a separate management team.

4. ***Management buyout***: The buyer is a group of managers, and the seller is the company that is compensated with both cash and shares. As a result, the publicly traded company goes private. To avoid lawsuits, the price paid is higher than the current market price. Shareholders receive a premium for their stock, while management retains control.

5. ***Spin-off***: A company divests a part of its operations by replacing its existing shares with two or more classes of shares, which represent the new, independent operations. Shareholders are compensated with new shares, and no money changes hands.

6. ***Split-off:*** This is a variation of a spin-off, where some parent company shareholders receive shares in a subsidiary in exchange for relinquishing their parent company shares. Split-offs are best suited for disposing of an investment stake in a subsidiary that is less than 100%. The purpose of the split-off is to reduce the pressure on the spun-off firm's share price, because shareholders who exchange their stock are less likely to sell the new stock. It also increases the earnings per share (EPS) of the firm initiating the split-off by reducing the number of its shares outstanding.

7. ***Split-up:*** Here a new class of stock is created for each of the parent's operating subsidiaries, paying current shareholders a dividend of each new class of stock. Finally, the remaining corporate shell is dissolved;

8. ***Sell-off***: This is the most common form of divestiture, where a seller agrees to sell one of its divisions to another company, the buyer.

9. ***Liquidation***: A company's division is sold off or its operations are wound down and the assets sold for cash. There can be many buyers, and payment is usually in cash only.

MOTIVES OF M&A[5,6]

For the sake of completeness, ten buyer motivations are reviewed below that can also influence the purchase price. Most of these are well known, and numerous others are described in various M&A textbooks and academic publications. All of these motives could lead a strategic buyer or financial sponsor to pay a price higher than that of an efficient market.

1. ***Synergy***: An increase in the value of assets as a result of their combination. The merged firm will have a greater value than the sum of its parts as a result of enhanced revenues and the cost base. Manager's overconfidence about expected synergies from M&A is often thought to result in overpayment for the target company.

2. ***Managerial motives***: The management team of the acquiring firm tends to benefit from the merger activity. The four most important managerial motives for merger are empire building, status, power, and remuneration. In empire building, managers have larger companies to manage and hence more power.

3. ***Tax advantages***: Past losses of an acquired subsidiary can be used to minimize present profits of the parent company and thus lower tax bills. Thus, firms have a reason to buy firms that have accumulated tax losses. Today, rules are in place to limit the ability of profitable companies to "shop" for loss making companies, limiting the tax motive of an acquiring company.

4. ***Risk diversification***: One of the reasons for conglomerate mergers is diversification of business risk. Systematic risk cannot be removed by diversification, thus mergers are not able to eliminate this risk. On the other hand, unsystematic risk can be spread through mergers. However, individual shareholders can achieve the same hedge by diversifying their portfolios at a much lower cost than those associated with a merger.

5. ***Geographical or other diversification***: This can be earnings management, attempting to smooth earnings to give conservative investors more confidence in investing in the company; however, this often fails to deliver value to shareholders.

6. ***Entry to new markets and industries***: A firm that wants to enter a new market but lacks the know-how can do so through the purchase of an existing player in that product or geographical market. This can sometimes make the two firms worth more together than separately.

7. ***Resource transfer***: Unevenly distributed resources across firms can be redistributed by a merger, which can also combine scarce resources or overcome information asymmetry.

3 Mergers, Acquisitions, and Other Restructuring Activities, by Donald DePamphilis (Academic Press, ©2005)

4 http://www.referenceforbusiness.com/encyclopedia/Con-Cos/Corporate-Divestiture.html

5 Mergers: What Can Go Wrong and How to Prevent It, by Patrick A. Gaughan (Wiley, ©2005)

6 http://justbuying.com/what-is-ma-mergers-and-acquisitions/motives-behind-ma/

8. *Economies of scale*: The combined company can often reduce its fixed costs by removing duplicate departments or operations, lowering the costs of the company relative to the same revenue stream, thus increasing profit margins. Horizontal mergers aim to reduce unit cost achieved by producing a large volume of a product. After growing to its optimal size, the firm may experience diseconomies of scale.

9. *Economies of scope*: This refers to the efficiencies primarily associated with demand-side changes, such as increasing or decreasing the scope of marketing and distribution, of different types of products. In the 1990s, cross-selling products were the driving force that created numerous financial conglomerates. A vertical merger of an upstream firm and a downstream firm makes coordination of closely related operating activities easier. Classic examples of vertical integration that provide economies of scope are today's supermajor oil companies and the Carnegie Steel company which controlled everything from the steel mills to coal mines, ships, railroads, etc. A roll-up or bolt-on acquisition is an example of lateral expansion, in which acquisitions of similar firms result in economies of scope.

10. *Increased revenue or market share*: The buyer absorbs a major competitor and thus increases its market power by capturing increased market share to set prices.

STATISTICS FOR MORE SCIENCE THAN ART

Typically on Wall Street, the pre-MBA analyst is responsible for screening and maintaining the list of comparable companies or transactions. But oftentimes, the managing director already has in mind the 2 or 3 key comps or transactions that will form the cornerstone of the list of comps or transactions, as well as the valuation range. This analyst assists the managing director in gathering the information to tell a story to close the deal.

Similarly, this occurs in bankruptcy or distressed situations, where different parties favor different valuations, e.g. debtors vs. creditors, seniors vs. juniors, and secured vs. unsecured. Thus, some unfavorable transactions which are omitted from the list of guideline company transactions might be just as interesting as those that are included by the valuation consultant or financial advisor.

In medical research, clinical studies, and science experiments, much thought is given to experimental design and sample determination. While the compilation of a list of guideline company transactions is not a hypothesis-driven science experiment or formal clinical study, objectivity and rigor may be increased by keeping in mind the statistical concepts of sampling bias, selection bias, survivor bias, and confirmation bias:

1. *Sampling bias*: A systematic error due to a non-random sample of a population is referred to as sampling bias. Because of problems with either the sampling technique or the data-collection method, the data is not random and no longer represents the entire population. While the comparable universe of transactions might be defined as all those occurring in the U.S. or North America (which includes Canada and Mexico), the true universe might actually also include Europe and/or Asia, for example. The world has become smaller, and multinational corporations and cross-border deals are the norm. Limiting screens to just U.S. deals involving large market capitalization companies could be an example of sampling bias.

2. *Selection bias*: This is a bias in sample assignment that results in the systematic over- or underrepresentation of a significant segment of the population. Sampling bias concerns the process of collecting the data, whereas selection bias concerns errors in any process thereafter. Omitting all precedent transactions with low purchase prices from the comparable universe of transactions is a common example of selection bias.

3. *Survivor bias*: The tendency to exclude from the sample any items that dropped out of the population and no longer exist due to poor performance or bad results is referred to as survivor bias. The most common finance example is when failed investment companies or fund managers are excluded from mutual fund (or hedge fund) performance evaluations or studies. This phenomenon overestimates the past returns of mutual fund families, since only successful funds are included in the sample.

4. *Confirmation bias*: This is the tendency to gather and filter only that information which confirms preconceptions, preferences, and hypotheses, even if the information is false or ambiguous. Using different databases and screening criteria can generate a long list of potential guideline transactions. While strong arguments could probably be made for the inclusion or exclusion of many of those candidate transactions, the overall pattern would reveal a confirmation bias upon close scrutiny. A future article on guideline company transactions (or guideline company comparables) in this section of *AIRA Journal* will discuss how to identify guideline companies and "good comps."

TAKE HOME MESSAGES

● When screening for guideline company transactions and trying to learn about the subtext of precedent M&A transactions, the typical approach is to explore the motives of M&A from the buyer's viewpoint.

● Also useful is considering the various motives of divestitures from the seller's viewpoint, since the seller's sales price is an important baseline in the negotiation process. Some types of divestitures do not have buyers and sellers or sufficient transaction data, making those transactions less useful for guideline company transactions.

● In generating a comparable universe of transactions, one should strive for more science than art. While the compilation of guideline company transactions is not a science experiment or clinical study, the statistical concepts of sampling bias, selection bias, survivor bias, and confirmation bias should be kept in mind.

This section on Valuation will soon rotate to the topic of rethinking capital asset pricing model (CAPM) inputs in today's economic cycle for Discounted Cash Flow (DCF) valuation.

Kenji Mochizuki, CIRA, Section Editor, is a General Securities Principal whose registrations include Series 7, 24, and 66 at Livingston Securities, LLC, a boutique investment banking and advisory group specializing in emerging technologies such as cleantech, energy, healthcare, and nanotechnology. He previously worked in the venture capital and hedge fund industries. Kenji Mochizuki may be contacted at 1(212)520-8468 or kenji@livingstonsecurities.com

NEW AIRA MEMBERS

D. Joshua Elliott
Grant Thornton LLP

Steven Reed
BGBC Partners, LLP

Laurie Rueber
Mainstream Management, LLC

David Bagley
MorrisAnderson & Assoc.

Claude Irmis
PEC, LLC

Christopher Good
Conway MacKenzie

Peter Kim
GLC Advisors

Steven Napier
Ernst & Young LLP

Michael Sellinger
GLC Advisors & Co., LLC

Bernard Costich
Bernard W. Costich, CPA, JD

Vikram Jindal
Rothschild, Inc.

Robert Ullman
Navigant Capital Advisors, LLC

Andrew Ruffo
Huron Consulting Group

Edward Kammeyer
The Platinum Group

Kenneth Benton
Navigant Capital Advisors

Jeremy Stern
FTI Consulting, Inc.

Emily Cartwright
FTI Consulting, Inc.

Michael Katzenstein
FTI Consulting, Inc.

Brent Worthy
FTI Consulting, Inc.

George Fang
Huron Consulting Group

Gregory Urbanchuk
Asterion, Inc.

Dale Kubiesa
Kubiesa & Assoc. P.C.

Shawn Creedon

Henry Mandell
Tatum LLC

Ainoor Sawhney
Deloitte

Sam McGowan
GLC Advisors & Co.

Joseph Pattaphongse
GLC Advisors & Co., LLC

Kimberly Thompson
FTI Consulting, Inc.

Kevin Byrnes
FTI Consulting, Inc.

Jaqueline Jiricek
FTI Consulting, Inc.

Stephen Dyott
FTI Consulting, Inc.

Kirsten Lundsten
FTI Consulting, Inc.

Connie Lau
FTI Consulting, Inc.

Rose Delarosa
Development Specialists, Inc.

Shaveta Singh
J.H. Cohn LLP

John Debus
FTI Consulting, Inc.
John Hyltin
Covendium

Alan Tantleff
FTI Consulting, Inc.

Steven Bissell
FTI Consulting, Inc.

Jodi Porepa
FTI Consulting, Inc.

Brian Corio
Alvarez & Marsal LLC

Joshua Smith
FTI Consulting, Inc.

Patrick Leimkuehler
FTI Consulting, Inc.

Daniel Dorfman
FTI Consulting, Inc.

Robert Jaynes
FTI Consulting, Inc.

Yohan Park
FTI Consulting, Inc.

David Jurgens
FTI Consulting, Inc.

Per Lindblom
KPMG

James Garber
FTI Consulting, Inc.

Christopher Hamilton
FTI Consulting, Inc.

Barry Rieger
Protiviti Inc.

Kayla Campbell
Protiviti Inc.

John McCarthy
Protiviti Inc.

Victor Lipnitsky
Invotex Group

Brian Jordan
CBIZ

Saleena Miller
Magnum Management Services

Phillip Greendyke
FTI Consulting, Inc.

Tamara Alsarraf
FTI Consulting, Inc.

Michael Baumkirchner
FTI Consulting, Inc.

Andreas Tsitsos
FTI Consulting, Inc.

John Vollbrecht
FTI Consulting, Inc.

M. Benjamin Jones
Conway, Del Genio, Gries & Co., LLC

Christian Hoveland
Bank of America Merrill Lynch

Alex Johnson
FTI Consulting, Inc.

Benjamin James
FTI Consulting, Inc.

Robin Majerle
FTI Consulting, Inc.

Alex Vayner
Net Business Growth

MEMBERS ON THE MOVE

The following members have recently changed firms, positions or addresses. Please update your contact lists. If you would like to report a recent move, please go online to www.aira.org

John Bonora
Gettry Marcus Stern & Lehrer CPA, P.C.
3 Park Avenue, 27th Floor
New York, NY 10016
jbonora@gmsiny.com

Douglas Brickley
The Claro Group
600 Travis Street, Suite 6950
Houston, TX 77002
dbrickley@theclarogroup.com

Mark Calvert
Cascade Capital Group LLC
7707 Fairway Ave SE, Unit 201
Snoqualmie, WA 98065
mark@cascadecapitalgroup.com

William Condon, Jr.
Condon Financial Consulting
1403 Calhoun St
Columbia, SC 29201
bill@billcondonlaw.com

Devin Daly
A&M Capital Real Estate, LLC
2301 Rosecrans Avenue, Suite 2110
El Segundo, CA 90245
ddaly@amcapitalre.com

David Hahn
Alpha Appraisal Consulting Group
14205 SE 36th Street #100
Bellevue, WA 98006
david@apcgwa.com

John Koskiewicz
Phoenix Management
6153 Velasco Ave.
Dallas, TX 75214
Jkoskiewicz@phoenixmanagement.com

Lee Matthew Smith
MatlinPatterson
520 Madison Avenue, 35th Floor
New York, NY 10022
smith@mpasset.com

Robert Tormey
XRoads Solutions Group
1821 East Dyer R. Suite 225
Santa Ana, CA 92705
bob@roberttormey.com

Jeffrey Whetzel
NewM Group
14414 Castle Cove Ln.
Houston, TX 77044
jrwhetzel@entouch.net

NEW CIRAS

Marta Alfonso
Morrison Brown Argiz & Farra LLP
Coral Gables, FL

John Baumgartner
Grant Thornton, LLC
Houston, TX

Charles Berk
CBIZ MHM, LLC
New York, NY

Michael Brown
Loughlin Meghji + Company
New York, NY

Melissa Brown
AlixPartners, LLP
Dallas, TX

Brian Christu
FTI Consulting, Inc.
New York, NY

Rodolfo Esquivel
New York, NY

Robert Frezza
Capstone Advisory Group, LLC
Saddle Brook, NJ

John Hall
Grassmueck Group
Portland, OR

Scott Javor
FTI Consulting, Inc.
Los Angeles, CA

Jeffrey Kelly
Restructuring Advisors
New York, NY

Thomas Lescher
Austin Financial Services, Inc.
Santa Monica, CA

Salvatore LoBiondo
Zolfo Cooper
New York, NY

Robert Loh
CBIZ MHM, LLC
New York, NY

Stephen Marotta
Marotta, Gund, Budd & Dzera, LLC
Parsippany, NJ

Scott Martinez
Zolfo Cooper
New York, NY

Teresa McMahon
Navigant Capital Advisors LLC
Chicago, IL

Christopher Nelms
FTI Consulting, Inc.
New York, NY

Lance Peterson
FTI Consulting, Inc.
Phoenix, AZ

Carl Seidman
Conway MacKenzie, Inc.
Chicago, IL

Colin Smith
C. Andrew Smith Associates Inc.
Toronto, Ontario

Jeffrey Sutton
CBIZ, Inc.
New York, NY

David Tsui
Capstone Advisory Group, LLC
New York, NY

Rahul Uppal
Grant Thornton LLP
Chicago, IL

CLUB 10

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

FTI Consulting, Inc.	**109**
Alvarez & Marsal North America, LLC	**77**
AlixPartners, LLP	**57**
Grant Thornton LLP	**36**
Zolfo Cooper	**30**
Capstone Advisory Group, LLC	**25**
Huron Consulting Group LLC	**25**
Mesirow Financial Consulting LLC	**23**
Deloitte.	**22**
BDO Consulting	**18**
LECG LLC	**18**
Navigant Capital Advisors LLC	**18**
Conway MacKenzie, Inc.	**17**
KPMG LLP	**17**
CRG Partners Group LLC	**16**
PricewaterhouseCoopers LLP	**14**
Protiviti Inc	**13**
Ernst & Young LLP	**10**
J H Cohn LLP	**10**
Office of the U.S. Trustee	**10**
EisnerAmper LLP	**9**
Goldin Associates LLC	**9**
Kapila & Company	**8**

Association of Insolvency & Restructuring Advisors™
221 Stewart Avenue, Suite 207
Medford, OR 97501
Phone: 541-858-1665
Fax: 541-858-9187
aira@aira.org
www.aira.org

CIRA

CDBV

AIRA Officers and Board of Directors