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**Larry Strauss, CIRA**
*University of Baltimore*

# *In re Majestic Star Casino:* The Shareholders Bet Big and Beat the Odds

***In re:* The Majestic Star Casino, LLC, et al, (CA 3 5/21/2013) 111 AFTR 2d ¶ 2013-742**

Courts have historically ruled that when an S corporation was in bankruptcy the S election was considered property of the bankruptcy estate. If a Shareholder revoked the S election it was deemed a violation of the automatic stay which prohibits "any act to obtain possession of property of the estate." See 11 U.S.C. §362. Furthermore, the trustee could seek to reverse such a prepetition revocation by the shareholders as a preferential transfer. *( In re Bakersfield Westar, Inc.),* 226 B.R. 227, 234 (B.A.P. 9th Cir.1998); *Halverson v. Funaro (In re Funaro),* 263 B.R. 892, 898 (B.A.P. 8th Cir.2001); *Hanrahan v. Walterman (In re Walterman Implement Inc.),* Bankr.No. 05–07284, 2006 WL 1562401, at *4 (Bankr.N.D.Iowa May 22, 2006). In a bold move under *Majestic Star Casino, LLC* the Third Circuit Court of Appeals strayed from this long standing position.

In *Majestic*, Barden Development, Inc. (BDI), an S Corporation had elected to treat its wholly owned subsidiary, Majestic Star Casino II (MSC II) as a QSub. BDI wanted to avoid approximately $170 million of debt cancellation income which would be generated from the disregarded QSub and flow through to the parent S corporation's shareholder. Mr. Barden the sole shareholder of BDI revoked the MSC II S election to shield the parent and himself from this phantom income thereby leaving the income tax liability in the bankruptcy estate. Due to the change in MSC II's tax status, MSC II would have to pay approximately $2.26 million in estimated income tax to the Indiana Department of Revenue for 2010 that it otherwise would not have had to pay. The Trustee filed an adversary complaint in the Bankruptcy Court, asserting that the revocation caused an unlawful post-petition transfer of MSC II's estate property, in violation of 11 U.S.C. §362. The bankruptcy court agreed and ordered the defendants, including the IRS, to take all actions necessary to restore the status of MSC II as a QSub of BDI.

The tax consequence of reinstating the S election places the tax burden of this income upon the parent's shareholder and not the debtor corporation. In addition, the bankruptcy court's order caused the IRS to lose the benefit of MSC II's tax liabilities being treated as an administrative expense of the bankruptcy estate, which would have allowed the government to be paid before most other creditors. See 11 U.S.C. § 503(b)(1)(B).

BDI and the IRS appealed the bankruptcy court's decision resulting in the case at issue. The spring board for this court's analysis is *Trans–Lines West,* 203 B.R 653. That case discussed the merits of the shareholder electing to revoke a debtor's S election in regards to motions for summary judgment by both parties. The *Majestic* court adopted the analysis that the S election is property of the shareholders and not trustee. It in turn rejects the argument made by *Trans-Lines West* that "once a corporation elects to be treated as an S corporation, 28 U.S.C. §1362(c) guarantees and protects the corporation's right to use and enjoy that status until it is terminated under 28 U.S.C. §1362(d)." The result of this case that a shareholder can revoke the S election goes against the majority of the case law until this point. I am of the opinion that *Majestic* is flawed in that it looks at the *Trans-Lines West* case as delineating the two sides of the issue whereby they must choose one or the other. However I believe both courts have taken an overly narrow approach which yields an unbalanced result.

The *Majestic* court found that the S election was property of the shareholders since the election and revocation is dependent on their consent. Furthermore they found that it was unfair for the shareholders to carry the burden of the tax consequences of the bankrupt entity where they would not be receiving the proceeds of liquidation to cover those taxes. I believe this court is wrong on both accounts.

Congress instituted the S corporation in 1958 due to the very high tax rates and their view that the larger corporations had too much power. Congress bestowed on select shareholders and their corporations the ability to avoid "Double Taxation." These shareholders were limited by their

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# A Letter From the President


**Anthony V. Sasso, CIRA**
*Deloitte CRG*


Hello, fellow members and friends of the AIRA. I hope that Summer has gone well for everyone and you are ready for a smooth transition into Fall. Looking ahead at the calendar for October and November, I would like to highlight two upcoming AIRA events: the Opening Reception at the 87th Annual National Conference of Bankruptcy Judges, and AIRA's 12th Annual Advanced Restructuring and Plan of Reorganization (POR) Conference in New York.

**NCBJ 2013 Opening Reception Sponsored by AIRA**

The 87th Annual NCBJ Conference will take place at the Marriott Marquis Hotel in downtown Atlanta, October 30 - November 2, 2013. As in prior years, the AIRA will be sponsoring the Opening Reception, which will unfold in the Marriott's Imperial Ballroom from 5:30 to 7:30 pm on October 30th. For all those attending the NCBJ this year, this is a great way to kick off your conference experience. This year's conference is expected to attract more than 150 bankruptcy judges and in excess of 1500 insolvency professionals. Consistent with prior years, we expect in the neighborhood of 1000 guests at the opening reception. Each year, this event proves to be a great opportunity to catch up with colleagues and friends and say hello to one or two of the many venerable bankruptcy judges who will be in attendance. A selection of great appetizers and a couple of cocktails are included, along with giveaway items from our corporate sponsors—so be sure to stop by for a rewarding two hours of networking and an overall entertaining experience!

**AIRA's 12th Annual Advanced Restructuring and POR Conference**

This year's POR Conference takes place on November 18th at its traditional venue, the Union League Club of New York. Since the inaugural year in 2002, we have had the good fortune to have some of the most outstanding Federal Bankruptcy Judges speak on our panels at this all day event, and this year promises to be no different. More details will be coming soon; but for now, reserve November 18th on your calendars and plan to attend this remarkable forum on significant issues impacting our profession during the past year and going forward. Up to 8 CPE / 7 CLE credits will be available. At the post conference cocktail reception, there will be an opportunity to chat with some of your favorite judges in an informal setting and to recognize Hon. Robert Gerber, Federal Bankruptcy Judge, Southern District of NY, for his many years of distinguished service. I hope to see you there for what will surely be a most informative and enjoyable program!

Tony Sasso

*To contribute to the newly established*

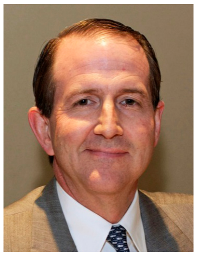
**AIRA Grant Newton Educational Endowment Fund**

*contact Elysia Harland, eharland@aira.org*

## A Note From the Executive Director

As described in the article below by David Payne, AIRA's Board is developing a set of standards for the valuation of distressed businesses. AIRA Directors David Bart, Tom Morrow and David Payne were appointed by the Board to serve as a committee to develop a draft of appropriate standards for valuation work performed by AIRA members. During AIRA's 29th Annual Conference in Chicago last June, the Board reviewed a preliminary draft of the Standards submitted by the committee. The Board will soon issue an Exposure Draft of the Standards and solicit comments from all AIRA members. I hope all members will take time to carefully read David Payne's article and the forthcoming Exposure Draft, submitting specific input and concerns during the comment period provided. I am sincerely grateful to and wish to recognize the valuation standards committee for their commitment to this project and dedication of their time and resources to supporting AIRA's objective to establish professional standards in this area of practice.

--Grant Newton, CIRA



# Exposure Draft of Distressed Business Valuation Standards Expected to Be Approved During 2013

**David R. Payne, CIRA, CDBV**
*D. R. Payne and Associates, Inc.*

The AIRA Board of Directors ("Board") has been considering the need to promulgate valuation standards ("Standards") for several years. The demand for Valuation Standards tailored to the unique issues and procedural processes experienced by trained insolvency and restructuring advisors has escalated in recent years. "Daubert motions and related rulings" have become commonplace in contested reorganization proceedings. Examples of unique issues not fully or commonly addressed by other recognized appraisal organizations include:

1. greater reliance on certain methods, such as the discounted cash flow method under the income approach, may be appropriate due to less reliable comparisons with non-distressed guideline transactions and market transactions methods;
2. greater use of hypothetical conditions such as assigned terms for a proposed plan of reorganization prior to approval or confirmation;
3. the reconstitution of tax attributes and their impact on future cash flows and reorganization value; and
4. impact of leverage on risk adjusted returns including the capital structure proposed in the plan.

During the last AIRA Annual Conference held in Chicago during June 2013, the Board reviewed a preliminary exposure draft of the Standards submitted by a Board appointed Valuation Standards Committee. The Board considered and/or incorporated a number of comments from non-Committee Board members and related valuation specialists from those firms represented by Board members. Once those comments are evaluated, the Board will circulate/post an exposure draft for broader comment.

In order to facilitate membership review and comment on the exposure draft, certain critical elements of the proposed Standards are summarized below:

### A. Standards Apply to Developing and Issuing an "Opinion of Value"

As described in the Standards, the term "engagement to estimate value" refers to an engagement or any part of an engagement that involves "estimating and/or developing an opinion of the value" of a subject interest. In the process of estimating value, the valuation analyst applies valuation approaches and methods, and uses professional judgment. The use of "professional judgment" is an essential component of "estimating value". The Standards do not draw any distinction between a full-scope or detailed engagement versus a restricted use or limited scope engagement or between a valuation engagement versus a calculation engagement.[1] The Standards apply "when performing engagements to estimate value *that culminate in an expression of an opinion or conclusion of value*" including but not limited to the following:

1. Developing an opinion of value regarding the reorganization value of the business enterprise or the related equity value available for old or new equity holders.
2. Developing an opinion of value regarding a sale of assets or a segment of the business.
3. Developing an opinion of value on the insolvency/solvency of the business enterprise at points in time.
4. Developing an opinion of value for assets and/or the business on a going concern, orderly or forced liquidation basis for purposes of assessing confirmation of a plan, conversion to Chapter 7 or for adequate protection.
5. Developing an opinion of value for financial reporting purposes including fresh start accounting.

[1] These types of engagement distinctions are identified by other appraisal organizations such as the AICPA, ASA and others. The AIRA has no opinion regarding the priority of standards among these organizations, and the AIRA has no opinion regarding the appropriate application of any standards that may differ between these organizations as they apply to the facts and circumstances of individual valuation engagements.

### B. Standards Apply and Are Binding on Certified Members

The Standard are binding on "AIRA Members who are a Certified Insolvency and Restructuring Advisor ("CIRA") and AIRA Members who have received a Certification in Distressed Business Valuation ("CDBV")".

### C. Standards Do Not Apply to Traditional Insolvency and Reorganization Consulting Services

Consulting services rendered in bankruptcy engagements as well as in other troubled debt situations are not subject to the Standards although such consulting services may rely, in part, on valuation techniques/calculations including:

1. Preparing and/or evaluating cash flow projections, sensitivity analysis and present value analysis for purposes of assessing viability and feasibility of the debtor.
2. Advising and assisting clients with forecasts and analysis of cash collateral, replacement collateral and collateral values provided by third parties.
3. Identifying an appropriate capital structure upon emergence, negotiating with creditors, assisting with developing a plan of reorganization and advising the client on potential plan actions utilizing third party indications of value.
4. Advising Chapter 11 creditors about voting to accept or reject a plan of reorganization based upon various financial metrics including valuation metrics provided by third parties. The reorganization plan outlines payouts to the different classes of creditors based on the value of the reorganized debtor. A creditor may vote to accept or reject a proposed plan. The financial advisor may advise the creditor to accept or reject a plan based upon the proposed payout under the plan as compared with the potential payout under an alternative scenario.
5. Performing the "best interests of creditors test" regarding the treatment of creditors under a proposed plan of reorganization under the U.S. Bankruptcy Code by evaluating (as opposed to developing an independent opinion) going concern versus liquidation values of the debtor.
6. Assessing the potential for (as opposed to developing an independent opinion) for insolvency at various dates in order to evaluate possible recovery actions.

### D. The Standards Include a Binding "Development Standard" to Support an Opinion of Value

The Development Standard included in the proposed AIRA Standards is generally consistent with the development standard set forth by other valuation/appraisal organizations including those published by the ASA, NACVA, IBA, CFA and AICPA[2].

The Development Standard requires that all appraisal principles, approaches, methods and calculations are required to be considered, rejected and/or applied in developing an opinion of value. However, a written valuation report is not required although quantitative exhibits, demonstratives, work schedules, data tables and/or summaries are usually necessary to support such an opinion. The valuators' work file should generally contain the same data and calculations whether or not a written valuation report is issued.

A valuation engagement requires written and/or oral narrative disclosure of the assumptions, methods and approaches used to determine a conclusion of value. In certain situations where the third party users are knowledgeable of the business, omission of certain narrative disclosures regarding the business, its assets and liabilities can be appropriate. The degree to which narrative disclosures may be omitted to satisfy the purpose, facts and circumstances of each particular engagement is a matter of professional judgment.

The Development Standard invokes a documentation requirement for information obtained and analyzed, procedures performed, valuation approaches and methods considered and used, and the conclusion of value. The quantity, type, and content of documentation are matters of the valuation analyst's professional judgment and experience considering the nature and purpose of the assignment.

### E. The Standards Include a "General-Report (Writing) Exception" Even When an Opinion of Value is Performed and Oral Reports Are Acceptable

The reporting Standards do not apply to litigation engagements in which a valuation analyst is engaged to testify as an expert witness in valuation, accounting, auditing, taxation, or other matters, given certain stipulated or assumed facts. A valuation performed for any matter before a court, an arbitrator, a mediator or other facilitator, or a matter in a governmental or administrative proceeding (herein referred to individually or collectively as "Controversy Proceedings"), is exempt from the reporting provisions of the Standards. The reporting exemption applies whether the matter proceeds to trial or settles. This exemption applies only to the reporting provisions of the Standards. The developmental provisions of the Standards still apply whenever the valuation analyst expresses a conclusion of value even in Controversy Proceedings.

An oral report may be used in a valuation engagement. An oral report should include "all information the valuation analyst believes necessary to relate the scope, assumptions, limitations, and the results of the engagement" so as to limit any misunderstandings between the analyst and the recipient of the oral report. The member should "document in the working papers" the substance of the oral report communicated to the client.

[2] Statement on Standards For Valuation Services No. 1

### F. The Standards Include a "General-Jurisdictional Exception" Even When an Opinion of Value is Performed

If any part of the Standards differs from published governmental, judicial, or accounting authority, or such authority specifies valuation methods or valuation reporting procedures, then the valuation analyst should follow the applicable published authority or stated procedures with respect to that part applicable to the valuation in which the valuation analyst is engaged. The other parts of the Standards continue in full force and effect.

One example of a jurisdictional exception in bankruptcy proceedings would be the consideration and/or use of "hindsight" in developing an opinion of value. In certain situations, bankruptcy courts have relied upon latter occurring events and data to determine value at an earlier date. Some examples include the decisions issued in the *Sunset Sales*[3] and *CFS*[4] cases regarding the measure of value for insolvency purposes in recovery actions. Ultimately, the use or application of any hindsight regarding subsequent events will depend on the purpose of the valuation and the intended user and should be fully disclosed in the valuation report.

### G. The Standards Include "Ten (10) Assignment – Specific Exceptions" Which Are Not Deemed to Encompass an Opinion of Value

1. Attest Exception – "The Standards are not applicable to a valuation analyst who participates in estimating the value of a subject interest as part of performing an attest engagement defined by Rule 101 of the AICPA Code of Professional Conduct (for example, as part of an audit, review, or compilation engagement)."
2. Government Regulation Exception – "The Standards are not applicable to a valuation that is performed pursuant to governmental regulation with a proscribed methodology, such as an ESOP valuation; however, if such a valuation is being performed in an insolvency context within the scope of these Standards, the analyst is expected to comply with these Standards and is expected to comply with the relevant reporting requirements of these Standards."
3. Client Provided Value Exception – "The Standards are not applicable when the value of a subject interest is provided to the valuation analyst by the client or a third party, and the member does not apply independently developed valuation approaches and methods, as discussed in the Standards. Sensitivity analysis performed on values determined by third parties is not considered an opinion of value subject to the Standards."
4. Sensitivity Analysis Exception – "The Standards are not applicable when the value of a subject interest is provided to the valuation analyst by the client or a third party, and the member does not apply independently developed valuation approaches and methods, as discussed in the Standards. Sensitivity analysis performed on values determined by third parties is not considered an opinion of value subject to the Standards."
5. Internal Use Employer-to-Employee Exception – "The Standards are not applicable to internal use assignments from employers to employee members of the AIRA."
6. Economic Damages and Lost Profits Exception – "The Standards are not applicable to engagements that are exclusively performed for the purpose of determining economic damages such as lost-profits unless those determinations include an engagement to estimate value. If a valuation analyst performs an engagement to estimate value to determine the loss of value of a business or intangible asset in connection with financial advisory services being rendered in the areas of business turnaround, restructuring and bankruptcy practice, then the Standards apply. A valuation analyst acting as an expert witness should evaluate whether the particular damages calculation constitutes an engagement to estimate value with respect to the business, business interest, security, or intangible asset or whether it constitutes a lost-profits computation. Present value calculations of future loss of profits are generally not considered an opinion of value even when income approach techniques are applied."
7. Mechanical Value Computations Exception – "The Standards are not applicable to mechanical computations that do not rise to the level of an engagement to estimate value; that is, when the valuation analyst does not apply valuation approaches and methods and does not use independent professional judgment and does not issue an opinion or conclusion on value."
8. Insufficient Data and Information Exception – "The Standards are not applicable when it is not practical or not reasonable to obtain or use relevant information; as a result, the valuation analyst is unable to apply valuation approaches and methods that are described in the Standards. Unless prohibited by statute or by rule, a valuation analyst may use the client's estimates for compliance reporting to a third party if the valuation analyst determines that the estimates are reasonable based on the facts and circumstances known to the valuation analyst."

3 *In re Sunset Sale, Inc.; Payne v. Clarendon National Insurance, et al.,* BAP WO-97-100 (Bankr. W.D. Okla. 1992)

4 *In re Commercial Services; NGU, Inc. v. Chase Manhattan, et al.,* 350 B.R. 520 (Bankr. N.D. Okla. 2005)

9. Financial Advice Exception – "Providing financial advice, without reference to developing independent values for various assets, is not subject to the Standards. However, if a valuation analyst independently calculates a value to illustrate various planning options, the analyst may fall under the Standards. Merely performing sensitivity analysis to value indications provided by third parties or the client is not subject to the Standards. If one or more of the assets for which value is to be determined is a business, business ownership interest, security, or intangible asset and is part of an engagement involving the fields of business turnaround, restructuring, bankruptcy and insolvency, and the client or a third party does not provide the values for these assets, or the valuation analyst does not use assumed or hypothetical values as part of the overall engagement, then the valuation analyst performing the valuation(s) is subject to the Standards with regard to these assets when determining an opinion of value."

10. Tangible Asset Exception – "The Standards do not apply to the assets or interests which constitute tangible assets as defined by the International Glossary of Business Valuation Terms, and which do not constitute a subject interest."

**H. The Standards Include a Binding Requirement to Disclose "Relevant and Materially Significant Restrictions and Limitations"**

All relevant and materially significant restrictions or limitations should be reasonably disclosed in any oral or written report including written materials that convey the results. For example, if a client instructed the valuator to apply only one approach or method to the exclusion of all other approaches there would be a scope limitation present. If, in the course of a valuation engagement, restrictions or limitations on the scope of the valuation analyst's work or the data available for analysis are so significant that the valuation analyst believes that he or she cannot, even with disclosure in the valuation report of the restrictions or limitations, adequately perform a valuation engagement leading to a conclusion of value, then the valuation analyst should consider terminating the valuation services subject to the Standards and assess the applicability of other consulting/advisory services.

**I. The Development Standard Requires Consideration of "Generally Recognized Valuation Principles, Approaches and Methods to Develop an Opinion of Value"**

In performing a valuation engagement, the valuation analyst should analyze the subject interest, consider and apply appropriate valuation approaches and methods, reconcile the indication of value to reach a conclusion of value, and maintain appropriate documentation. The development standards and generally recognized report disclosures include:

1. Identify and Define the Subject Business Ownership Interest and/or Assets and Their Nature
2. Define the Purpose of Intended Use of the Valuation
3. Identify the Premise of Value
4. Identify the Standard of Value
5. Identify and Select a Valuation Date
6. Compile Non-Financial and Qualitative Information
7. Compile Financial and Qualitative Information
8. Identify Key Assumptions and Limited Conditions
9. Identify Valuation Approaches
10. Consider and Apply Valuation Adjustments (Premiums and Discounts)
11. Develop Reconciliation and/or Correlate a Conclusion or Opinion of Value

The Board has been highly cognizant of the nature and extent of financial advisory/consulting services provided by its members which should, and should not, be subject to the proposed Standards. The Valuation Standards Committee has incorporated numerous general and assignment-specific exceptions to the Standards which meet the Board's objectives of fostering best practices in the provision of advisory services that promulgate basic Standards of practice regarding distressed situations. These Standards should be followed by members of the AIRA who are practicing valuation services, and should generally not be in conflict with other professional standards the members may hold.

When the exposure draft for the Standards is posted for final review by the AIRA membership, further comments can be provided to any or all the Valuation Standards Committee members at the following addresses:

David Bart – David.Bart@mcgladrey.com
David Payne – drpayne@drpayne.com
Tom Morrow – Tmorrow@alixpartners.com
Grant Newton – gnewton@aira.org

Special thanks and acknowledgement is given to the Valuation Standards Committee for their commitment and dedication to supporting AIRA's objectives to promote best practices within our service area by setting basic standards for professional competency. ■

***David R. Payne, CIRA, CDBV, CPA/ABV, CTP, ASA,*** *is Firm Managing Director of D. R. Payne and Associates, Inc. He has over 20 years of experience in accounting, appraisal, management and consulting, in both private industry and the public sector. He has served as interim chief executive officer or financial officer during turnarounds and restructurings, court appointed trustee and receiver, as well as expert witness in matters of appraisal and damage assessments. Before organizing D.R. Payne and Associates, David was a partner in the Consulting Group of KPMG Peat Marwick.*

# Leadership Amid Chaos: Lessons Learned in the Trenches

**Philip Daddona**
*FTI Consulting, Inc.*

**Terrence Grossman**
*Accordion Partners*

It often is described as the emergency room of business — a chaotic situation that needs to be addressed immediately and resolved promptly. A company's very existence frequently depends on taking the appropriate action during a crisis. It might be the beginning of an entirely new direction, a transformation of the organization — or the beginning of the end. It is a defining moment where bold actions are required with no assurance of success, while timidity, indecisiveness or incremental measures almost certainly will mean failure. It could be a business in sudden free fall or a large acquisition whose integration has gone terribly wrong. Or maybe it is the seemingly impossible mission for which you have been tasked.

It is the precipice of a crisis — the moment when every business leader is tested under fire and the organization must collectively abandon business-as-usual attitudes. Elective surgery has to wait when a patient is hemorrhaging. These situations require decisive measures by credible leaders in order to have any chance of succeeding. Subordinates will need to trust the leadership and have confidence in its ability to guide the organization though the ordeal.

Financial advisors build their careers and reputations in these situations. Since most managers rarely encounter these circumstances in their working career, the leadership skills and management principles upon which executives rely for daily operating decisions may not apply, and other attributes or principles must come to the fore. The outcome is not entirely controllable nor is it always the optimal one, but it is edifying to reflect on what was done well and what could have been handled better. Often, it comes down to process and execution, but the overarching determinant is effective leadership.

Critical self-assessment is a hallmark of effective leaders and provides valuable insight for experiences yet to come. Below are some of the most important lessons we have learned along the way.

### ESSENTIAL PRINCIPLES OF LEADERSHIP AMID CHAOS

1. Quickly develop an end game.
2. Start with the organization: its people and structure.
3. Communicate. Communicate. Communicate. And when you have finished communicating, communicate some more.
4. Seek the counsel of others.
5. Remove obstacles.
6. Manage by exception.
7. Empower people.
8. Remember that perfect is the enemy of good.
9. Leave the PowerPoint presentation at home.
10. Motivate and engage at all levels.
11. Establish a routine.

### 1. Quickly Develop an End Game

If the leader is unsettled in a chaotic situation, imagine how subordinates must feel. One of the primary jobs of a leader in such situations is to quickly provide specific guidance, direction and focus. Instill confidence throughout the enterprise that there is a destination and a road map. If this path is not evident to subordinates, a chaotic situation likely will beget failure. Although it is not the ultimate objective, alleviating the impact of a crisis by promptly identifying and prioritizing issues and formulating a strategy and credible plan is essential if that objective is to be met. In the first days of its bankruptcy, MF Global Holdings, the primary holding company, was collapsing, and there was considerable doubt as to whether it could even meet its biweekly payroll obligations, let alone its Chapter 11 charge of an orderly business wind down. The company required swift actions to stabilize its operating platform by securing capital, reducing expenses, establishing a cash management system that segregated cash and ensuring that employees were paid on a timely basis. Distractions were abundant: Significant client funds were missing, most subsidiaries were under local jurisdiction administration and questions swirled over transactions that immediately preceded the bankruptcy, which may have contributed to the company's collapse. Had we instead focused on these particular issues, cash resources would have been exhausted in no time, likely putting the company in Chapter 7 liquidation. Our actions in those early days stabilized the situation and made it possible for the company to pursue an orderly wind down strategy to maximize recovery for its creditors.

However, be cautioned that leaders in chaotic environments should not live entirely in the moment either. Balancing immediate objectives and longer-term goals is an ongoing challenge in a crisis. Subordinates need to understand where their collective efforts are expected to take the enterprise and the plan for getting there. Their confidence fades as the ability to plan and execute is degraded. But it may take time to develop an end game, so periodic updates to personnel will help maintain morale.

### 2. Start with the organization: its people and structure.

Some people refer to it as a project management organization, transaction team or turnaround group, depending on the circumstances. This is the first step in bringing a measure of planning and accountability to the process. Getting the most adept people for the job in the right structure sounds simple, but the failure to do so is a major reason that chaotic conditions persist, a crisis deepens and failure prevails. Utilize people with a proven track record of decisiveness, execution and demonstrated leadership skills. The project team needs to be lean, focused and structured to break through internal bureaucracies, clear obstacles, facilitate key objectives and maintain discretion so the rest of the organization is not distracted from running the day-to-day business. The objective is swift action while maintaining control of the situation. In several instances, we have encountered cases where the transition team did not have the right individuals leading vital workstreams. Some employees who politicized adversity, hoarded information for control purposes, contributed to needless bureaucracy or simply lacked the proper skills were given key roles based largely on their job titles. Such inapt choices can severely hinder the process or can cause it to fail. Hence, a crisis environment often warrants personnel changes at various levels of the organization.

At a minimum, senior leadership will be distracted from routine duties at a most inopportune time. Assess early on what gaps exist and develop a plan to augment those gaps with internal and external resources. For example, during an expedited acquisition transaction and integration process, we were able to promptly identify areas and workstreams requiring additional or stronger resources. Management recognized that the daily organizational structure would not work effectively and quickly made decisions to supplement those areas with support that enabled the individuals to operate autonomously. Be realistic with the gap assessment and determine if outside assistance is required. Do not fall victim to the famous line: "If only they had called me yesterday." As time lapses, so do options.

The appropriate process that augments the right people also is critical. Too many meetings, too many reports and too much bureaucracy inevitably will diminish the sense of urgency and frustrate the go-getters. Undue time spent on reports, presentations and non-critical analyses leaves less time for resolving key issues.

### 3. Communicate. Communicate. Communicate. And when you have finished communicating, communicate some more.

Communication is essential to keeping everyone focused and on point. Continually ensure that messaging is getting where it needs to go for maximum effect and efficient execution at all levels. Consistency is imperative; this is no time for ambiguity or misinterpretation. Since extra layers in an organization often increase the likelihood that messaging will be diluted or will get lost in translation when conditions are chaotic, we frequently employ all-inclusive "war room" meetings.

In one fast-paced case, we held meetings early each morning so everyone would be available to attend and would be informed and aligned when the workday started. The meeting soon grew from 15 to 70 attendees. Nearly everyone participated, including senior leadership, mostly in listen-only mode. These meetings were organized and structured and never lasted more than an hour. Each workstream leader was encouraged to raise issues, and senior management would either make a decision on the spot or continue the conversation offline with the relevant people, with a follow-up the next day to the group. It was an efficient way of ensuring that everyone heard these updates and that no misunderstandings were forming.

Communication needs to be concise, thoughtful and, perhaps, blunt. Many times, the message is lost if it comes across as pompous, detached, impersonal or abstract. In one bankruptcy case, we conducted a training class for handling important accounts payable requirements following the company's Chapter 11 filing. People were nervous about the company's survival prospects and about their own job security, and these new duties were a major deviation from the way these individuals conducted business under normal circumstances. We had to gain their trust and focus them on their latest priorities. One time, a senior leader who had dropped in to observe the training began discussing technical and strategic concepts that were better left for the boardroom and then began name-dropping to impress the group. In no time, we lost the audience and had to back up and re-establish trust with this principal team.

Finally, get in the trenches instead of holing up in the executive suite. It is the best way to ensure the message is permeating the organization. This is not the time for surveys or focus groups. Employees need to see their leaders during a crisis.

### 4. Seek the counsel of others.

Leaders are wise to surround themselves with talented people who complement a leader's skill set. Solicit the advice and guidance they can provide. Good leaders recognize their weaknesses and skill gaps, and the best way to overcome a shortcoming is to augment one's team with individuals who can compensate for these deficiencies. An insecure executive is not an effective leader in any situation — let alone in a crisis. A leader almost always will need to depend on the specific expertise of certain hard-working, talented individuals within the company in order to do the job effectively.

Financial advisors won't always be experts in every aspect of an industry nor are they intimately familiar with how any particular business operates in the trenches. Thus, in order to be successful, they will need to engage people who possess such specific knowledge. This does not necessarily mean senior management only; oftentimes, we rely on capable subject matter experts who have the skills to timely identify issues and drive processes as we manage the end game. Decisions will need to be made in an expedited manner so seek guidance and welcome counsel. It does not need to be lonely at the top. However, the bigger the talent or reputation, the greater the expectation is to accomplish lofty goals. Welcome that challenge.

### 5. Remove obstacles.

The primary job of a leader is to execute once an end game is developed, a structure is put in place and the team is ready. Nothing saps morale or slows momentum like bureaucracy, politics or hidden agendas. In a chaotic situation where time is of the essence, it is the leader's job to break through the stranglehold of bureaucracy, address hidden agendas and remove road blocks to developing solutions. This is the point where a leader's credibility is either established or broken. Managers who dictate to their subordinates to "just get the job done" or make demands without offering specific guidance or solutions only elevate the level of anxiety and eventually lose the support of the staff. Such individuals will be perceived as ineffective managers incapable of problem solving. A leader must be the primary servant to the process in order to gain the necessary buy-in from the team. In a chaotic situation, the most important questions a leader can ask are: "What are your issues?" "What is preventing you from doing your job effectively?" and "How can I help?"

Decisiveness and bold action are key leadership traits that must be on display when a process gets bogged down. As former GE CEO Jack Welch once said, "The way to harness the power of your people is to turn them loose and get the management layers off their backs, the bureaucratic shackles off their feet and the functional barriers out of their way."[1] A leader must be continually evaluating people and processes, as well as one's own effectiveness. Again, hard decisions have to be made, and careers will be impacted. In one instance, an acquisition was not getting traction: A closing condition related to the establishment of a transition services agreement was fast approaching, and the process was perilously behind schedule. A quick look at the circumstances revealed that the leader of this process demanded total control — everything had to go through him, and he insisted on being involved in every meeting and call. Communication was entirely one way. We realized early on that three changes had to be made: 1) the current manager needed to be removed from the situation; 2) the experts who intricately knew the transition requirements for the acquisition needed to be empowered to work with their counterparts to establish these mandates and 3) guidance and two-way communication had to be implemented posthaste. Although senior management was concerned about the disruption of removing this individual from the process, bureaucratic snags fell away once that particular manager was gone. The company soon established credibility with its counterparts on the other side of the transaction, and, with only a slight adjustment to the timeline, the transition process was completed before closing.

### 6. Manage by exception.

In chaotic situations, a leader's time is precious, and issues can be overwhelming. The ability to see "the big picture" and pinpoint issues that are essential to success is a required attribute of great leaders. In order to effectively move forward amid crisis, a leader must pick his/her battles and determine which issues are mission critical and command the utmost attention. A leader cannot possibly take on all pressing issues and expect to be successful. Some issues can be dealt with later, some must be entrusted to others and certain tasks can be relegated to a lower priority status. Gary Crittenden, the former Chief Financial Officer of Melville Corporation, Sears and American Express, was a master at managing by exception. A Sears executive once said that he could "look at 100 dots on the wall and say, 'I'm going to focus on this one'."[2] In 1996, Crittenden and Senior Vice President and Treasurer Phil Galbo developed and Galbo executed a plan to transform Melville Corporation, an underperforming and struggling retail conglomerate with banners such as Kay Bee Toys, Thom McAn, Marshalls and crown jewel CVS division, into the CVS Corporation by divesting nine retail chains while acquiring a major drug chain, Revco. Though each transaction that was required to accomplish this feat could be dissected and found flawed to some degree, Crittenden and Galbo steered the team to the ultimate goal, kept the plan relatively basic and did not obsess needlessly over minor details. The transformation was successfully completed in one year, and CVS soon thereafter emerged as an industry leader. It was management by exception at its best.

Issues that may be important in a normal operating environment often become a distraction in a chaotic situation. Getting bogged down in minor details can easily derail a focused process. As mentioned previously, in chaotic situations, it is not unusual for us to convene war room meetings to discuss crucial issues and provide guidance for resolving important problems. During these meetings, little time is spent discussing areas that are going right. We concentrate extensively on those that are flashing red. By establishing guidelines early on for reporting issues and risks, we trust people to drive progress and manage the details.

### 7. Empower people.

An effective leader will need to delegate decision-making responsibility in order to drive a process or workstream to its conclusion. A crisis is not the time for micromanagement, risk avoidance or constant second guessing. However, while responsibility can be delegated, accountability cannot be. For people to feel empowered, they need to know that the leader has their backs and will support them at critical moments. This aspect is essential to managing through a crisis. To quote Warren Bennis, one of the world's top experts on leadership, "Managers do things right while leaders do the right thing."[3] To truly empower people, there must be trust. Empowerment often is thought of as one directional when, in reality, it is a two-way street. Subordinates need to feel that a leader is authentic and sincere in order to act effectively. There have been many instances where leaders provide upfront guidance and assurances and say the right words initially, only to follow with second guessing and admonishment when something does not go according to plan.

In a recent case, internal subject matter experts with far greater technical knowledge than ours were brought in to identify issues and monitor progress. Some were given more responsibility than they had prior to the crisis. But because we demonstrated trust in them and gave them a mandate upon which to act, they stepped up and performed admirably at a higher level, and the crisis was readily contained.

### 8. Remember that perfect is the enemy of good.

Six Sigma principles can make a good company a great one, but they can be the kiss of death in a crisis situation. The dying patient will expire on the operating table if the doctor's attention is on superficial wounds. It is up to the leader to set these priorities and avoid "paralysis by analysis." In a chaotic environment that is in constant flux, there are few certainties. We have seen managers ruminate over relatively minor issues or details in developing a liquidity plan; request reams of supporting documentation and analytics; create large, complex financial models; and demand reconciliations that tie out to the penny, all while cash is running low. Tasks or projects that should take only days easily can turn into weeks. Meanwhile, the cash burn continues, much of it on expendable outlays. Process complexities that frequently pervade a normal operating environment need to be simplified or minimized during a crisis, and some tradeoffs between precision and timing may be acceptable.

1 "Jack Welch & the G.E. Way: Management Insights and Leadership Secrets of the Legendary CEO" by Robert Slater; McGraw-Hill, 1998

2 "Sears: The Turnaround is Ending; The Revolution Has Begun" by Patricia Sellers; Fortune Magazine, Apr 28 1997

3 "Leaders: Strategies for Taking Charge" by Warren G. Bennis and Burt Nanus; HarperBusiness, 2003

**9. Leave the PowerPoint presentation at home.**

This advice probably is counterintuitive for many professionals. A client once remarked that the best thing we did for him was not overwhelming him with PowerPoint presentations. In a crisis situation, keep facts as simple as possible when working toward a favorable resolution of issues. Information overload can be paralyzing, and data overload can be fatal. Gen. William Marshall, a former New Jersey Army National Guard Commander, always told his staff during briefings to give him information, not data. By making it quick and keeping it simple, he could give guidance. He did not want to spend his time figuring out the situation. While formal presentations and reports can be useful for conveying information in an orderly setting, during hectic, highly charged situations where information is rapidly changing and new updates and issues are emerging with regularity, we, instead, maintain a master issue log that drives war room discussions. Communicating less formally but more frequently via these meetings is far more effective than drawn-out PowerPoint presentations, which quickly would be stale in any event.

**10. Motivate and engage at all levels.**

When there is uncertainty throughout an organization, rumors will abound and unfounded gossip will permeate lunchroom chatter. This is where a leader needs to be the face of the organization, the source of positive attitude and a master motivator. A wizard behind a curtain will not work. A leader needs to be among the troops and on the ground, gauging attitudes, morale and facts. When leaders are not physically present, they are perceived to be aloof and unengaged. Instead of e-mails from a distant executive suite, conduct town hall meetings with regular follow-ups. Make time daily to walk the halls, listen to people and let them know their contributions are valued. It is amazing how much effort an energized leader can get from his/ her people. In turn, the displays of appreciation that are reciprocated once a crisis has passed are quite gratifying. At the other end of the spectrum, coercion and fear never will motivate people to do more than the minimum. Personally acknowledge achievement but also maintain candor throughout the crisis. Not everything will go according to plan, and setbacks along the way are inevitable. People appreciate being told the truth promptly. It shows integrity in leadership.

**11. Establish a routine.**

Like a football coach, a leader in a highly challenging situation wants his team to peak at the right time. Every new day cannot entail another fire drill. There needs to be a semblance of organizational normalcy or people will burn out. The sooner an end game is developed, guidance is provided and a routine is created, the sooner anxieties will begin to dissipate. A major objective of any leader should be to move the organization back toward a sense of normalcy as rapidly as conditions allow.

**Conclusion**

A chaotic situation tests management's hands-on abilities and leadership skills. Strong management under extremely trying conditions is essential to providing direction for stakeholders and encouraging them to follow the course that has been set. Colin Powell, retired four-star general in the U.S. Army and former U.S. Secretary of State, defined it this way, "Leadership is the art of accomplishing more than the science of management says is possible."[4]

So, based on our discussion here, is restoring order from chaos an art or a science? It is actually both, but for a leader to succeed, there are key factors to remember:

**Be genuine.** Throughout all actions and communications, a leader should not deviate from one's normal personal characteristics and behavior. Trying to imitate some ideal or prototype as a leader just will not work. People will show commitment only to someone they trust. Building trust comes from open and genuine communication, a willingness to acknowledge mistakes, a desire to be held accountable, and a determination to be deeply committed to the success of the team and the mission.

**Believe in people.** Engage with and trust people. It is a leader's obligation to provide the vision. Have confidence in people to execute on that vision. Help and guide them along the way and be sure to praise them when important milestones are reached. The goodwill created by these actions will provide the impetus to cross the finish line.

**Celebrate success.** Oftentimes, especially in chaotic situations, one does not know what winning looks like. Small victories on the path to creating order need to be appropriately recognized. If the task seems overwhelming, people will have a tendency to give up easily. Celebrate discernible accomplishments as stepping stones to achieving the ultimate success of the project.

Leadership amid chaos requires vision, commitment, accountability and integrity. There is no greater reward than witnessing the development of people in a challenging environment. Watching others flourish under trying circumstances strengthens the organization and creates unforgettable lessons for everyone involved. The satisfaction of a job well done can be rivaled only by the careers enriched by such an experience.

The views expressed herein are those of the authors and may not necessarily reflect the views of FTI Consulting, Inc. and its other professionals. ■

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[4] "The Powell Principles: 24 Lessons from Colin Powell, a Battle-Proven Leader" by Oren Harari; McGraw-Hill, 2004

# Major League Baseball Bankruptcies

**Forrest Lewis, CPA**

This is the second of two articles covering major league sports bankruptcies. The first article focused on National Hockey League bankruptcies (see previous edition *AIRA Journal Vol. 27: No. 1*). This article covers the recent bankruptcies by the Texas Rangers and the Los Angeles Dodgers.

Bankruptcies among franchises in the four major league sports in the United States have been fairly rare in the last twenty years. While there have been many franchises in financial trouble, usually the league has been able to broker a sale before an actual petition in bankruptcy has been filed by the team.[1] In the filed cases, all have resulted in sales of the teams and apparently none have involved losses to unsecured third party creditors as is common in bankruptcy.

Sports bankruptcies present several unique aspects. Usually there is a league franchise agreement which purports to give it power over a financially troubled franchise including veto power over prospective buyers—in some cases that has led to assertion of anti-trust issues. Typically there is a very expensive stadium for which a team can have long term lease obligations running 30 years or more. In most cases there is an unusual relationship with the home city; there is also high emotional fan and civic attachment to the team, much more than encountered in the potential sale and relocation of other types of businesses. As portrayed in the *Seinfeld* television series, everyone in town feels they have a say in the running of the city's major sports teams. Historically, the stadiums were privately owned by the franchise owners but in the last 30 years a major trend has been for the municipality to facilitate team finances by building the stadiums and providing long term leases to the team. On the other hand, those same long term leases create a huge executory contract in a bankruptcy scenario. Indeed, the feeling of "ownership" by the citizenry often has a basis in fact.

## STRUCTURE OF MAJOR LEAGUE BASEBALL

Much of the current structure of Major League Baseball stems from the infamous "Black Sox" scandal of 1919 in which an illegal bookmaker attempted to influence the outcome of the World Series by bribing certain members of the Chicago White Sox, possibly including "Shoeless" Joe Jackson depicted in the movie *Field of Dreams*. In 1921 the major leagues revamped their constitution and did away with the old National Commission which had run professional baseball by committee. The principles and much of the language of the 1921 agreement still form a major part of the Major League Constitution.[2] The Constitution places a great deal of emphasis on the integrity of the game and gives a tremendous amount of power to the Commissioner to act "in the best interests of baseball." The Constitution requires a three-fourths vote for a team to make an ownership change.[3] It also contains a more drastic provision subjecting a franchise termination for failing to pay its bills or filing a petition in bankruptcy.[4] Most other professional sports seem to have followed the baseball legal model. Operations of the Commissioner of Baseball's office are somewhat mysterious at this point in time. It operated as a federally tax exempt business league under Internal Revenue Code Section 501(c)(6) from 1942 until 2007, at which time the exempt status was apparently dropped, perhaps to avoid disclosing salaries and other internal information. The last IRS form 990 filed by the League was for 2006 (it disclosed Commissioner Selig made $17.4 million that year). The MLB may have had to pay tax on the conversion to a taxable organization under Internal Revenue Code Section 337(d).

Finally, it is important to note that Baseball has pursued a "rich owner" business model as cycles of boom and bust are common in professional team sports and a team's owner must have deep pockets to fund operations during down cycles. Only the Green Bay Packers deviate from this model among the four major league sports as they are still a publicly traded corporation. Indeed, most of the hockey and baseball bankruptcies have been initiated by personal financial problems of the owners and their inability to finance the team through cashflow problems.

## TEXAS RANGERS

The franchise was established in 1961 by the name of the Washington Senators, an expansion team awarded to Washington, D.C., after the city's first ballclub, the original Washington Senators, moved to Minnesota and became the Twins. As such, they subscribed to the Major League Constitution and the Membership Agreement,[5] dated November 18, 1960, by and between The American League of Professional Baseball Clubs, which were assumed by all subsequent purchasers. After the 1971 season, the new Senators moved to Arlington, Texas, and became the Rangers the following spring.[6] The Rangers faced attendance problems off and on, in part due to the team's inconsistent performance and in part due to the oppressive heat and humidity that often afflicts the area in the summer. Until the Florida Marlins arrived in 1993, Arlington Stadium was often the hottest stadium in the Majors, with temperatures frequently topping around 100 degrees throughout the months of summer. In part because of this, the Rangers began playing most of even their weekend games between May and September at night. They usually get a waiver from ESPN to play Sunday night games.

In April 1989, Rangers owner and oil tycoon Eddie Chiles, sold the team to an investment group headed by George W. Bush,

[1] The Baltimore Orioles were sold in 1993 as a result of the bankruptcy of their owner Eli Jacobs, but the team did not file a petition itself. The Chicago Cubs did file a petition in 2009 for administrative convenience as part of the Tribune Company bankruptcy but were sold to the Ricketts family. See article in this column in Volume 26, number 2 in 2012.

[2] Although the Major League Constitution is not a public document, one alleged copy of it as of 2005 has been published on the internet, http://bizofbaseball.com/docs/MLConsititutionJune2005Update.pdf This article assumes that copy is genuine and cites passages of it.

[3] M L Constitution, Sec. 2(b).

[4] *Ibid*, Sec. 4

[5] NORTHERN DISTRICT OF TEXAS Case No. 10-43400 (DML)-11, Disclosure Statement, p. 1

[6] Except as noted, most of the rest of the background information on the Rangers is taken from the Wikipedia article "Texas Rangers (baseball)"

son of the President of the United States, George H. W. Bush. George W. Bush headed a group of investors that bought the team for $89 million. While his own equity in the team was a small one (approximately 1%), he was named Managing General Partner of the new ownership group. He increased his investment the following year.

During his tenure, the Rangers and the City of Arlington decided to replace the aging Arlington Stadium with a new publicly funded stadium, at a cost of $193 million, financed by Arlington residents, through a sales tax increase. Ground was broken on October 30, 1991 on what would become The Ballpark in Arlington (now named Rangers Ballpark in Arlington). The city, through the Arlington Sports Facilities Development Authority, also controversially authorized the seizure of 13 acres of land through eminent domain for the Rangers future development. Landowners filed lawsuits over the acquisition and eventually won settlements of $22.2 million which the Rangers failed to immediately pay. Bush left his position with the Rangers when he was elected Governor of Texas in 1994. In 1998, venture capital billionaire Tom Hicks bought the team for $250 million. Hicks also agreed to pay the $22.2 million awarded in settlements in relation to the 1991 eminent domain litigation concerning the Ballpark in Arlington.

Later, Hicks became the focus of several reports indicating serious financial problems with his holding group, Hicks Sports Group (HSG), which also owned the Dallas Stars, the Frisco Roughriders (the Rangers AA-farm club), 1/2 of soccer team Liverpool F.C. (sold in mid-October 2010 to New England Sports Ventures, owners of the Boston Red Sox), and the Mesquite Championship Rodeo (later sold by HSG). HSG was reported to have gone into default on a $525 million loan. Between 2005 and 2009 Hicks injected $100 million into the Rangers via capital contributions and loans.[7] In April 2009, Hicks announced he would be willing to sell a minority interest in the team. One month later, Hicks announced he would be willing to sell majority control of the Rangers. The Rangers had borrowed money from Major League Baseball to meet the team's payroll via an entity called "Baseball Finance, LLC" which is operated by the Commissioner's office.[8] After the 2009 season, Hicks began soliciting prospective buyers and in December entered into exclusive negotiating rights for sale of the Rangers with a consortium headed by Pittsburgh sports lawyer Chuck Greenberg and Rangers team president and Hall of Fame pitcher, Nolan Ryan. Interestingly, Greenberg represented Mario Lemieux in his acquisition of the Penguins.[9]

On January 22, 2010, Hicks Sports Group officially reached a formal agreement to sell the Texas Rangers to the group headed by Greenberg and Ryan for approximately $570 million. Under the provisions of the deal, former owner Hicks stayed on as a limited minority partner, but was not allowed to retain a seat on the board of governors. Co-lead investors Dallas businessmen Ray Davis, and Bob R. Simpson were named co-chairmen. Hicks also sold much of the land surrounding Rangers Ballpark to them in a separate deal.

The deal was subject to approval by the other MLB owners (a 3/4 vote is required) and completed by April 1 in time for opening day. However, some of HSG's 40 creditors including Monarch Alternative Capital opposed the sale on grounds that the proceeds would not fully repay the defaulted HSG notes.[10] On April 21, Major League Baseball issued a statement declaring the Rangers' sale to be under the control of the Commissioner to expedite the process. Because of public comments made by Hicks deemed detrimental to the process, MLB also stripped Hicks of any responsibility regarding the sale of the team. On May 13, MLB threatened to seize control of the rest of the team's operations if a deal was not completed by the deadline set by the Commissioner.

As the stalemate between HSG and its creditors continued, on May 24, 2010 the Texas Rangers filed a pre-packaged plan for Chapter 11 bankruptcy.[11] As of that date, the Rangers and HSG had an estimated debt of $575 million. Much of the unsecured debt was owed in back salary. Officially, New York Yankees third baseman Alex Rodriguez topped the list of unsecured creditors with an estimated $24.9 million owed by the Rangers. Additionally, the Rangers also owed Baltimore Orioles pitcher Kevin Millwood $12.9 million, and current Rangers third baseman Michael Young $3.9 million. At a press conference, the Greenberg-Ryan group proposed to buy the team for $570 million. The sale would repay all the team's creditors, including players owed back salary. Immediately after the filing, Greenberg, Ryan and Hicks met with the team to reassure them that the purpose of the filing was to expedite the sale and that their salaries would be paid. Player Michael Young described the meeting. "After a huge sigh of relief, the meeting went on…once we knew (bankruptcy) was a way to expedite the sale, we knew it wasn't that big of a deal." Also, Ryan and Greenberg were in touch with the players union whose President said he has "been assured that all contractual commitments to players will be honored in full."[12]

After several attempts by the court to complete the sale fell through, the court ordered a public auction to be held on August 4. The Greenberg/Ryan bid would be the opening bid, and other offers (subject to MLB approval) would have to be submitted by the prior day in order to be considered. At the auction, only one other MLB-approved group submitted an offer – Radical Baseball LLC, a group formed by Houston businessman Jim Crane (who was previously unsuccessful in buying the Houston Astros, and ultimately bought that team in 2011) and Dallas Mavericks owner Mark Cuban (who was previously unsuccessful in buying the Chicago Cubs). The auction lasted until the early morning of August 5, with the winning bid submitted by Greenberg/Ryan. The bankruptcy court approved the bid later that morning and the bankruptcy case closed. The sale to the Greenberg/Ryan was approved by all 30 MLB owners at the owners' meeting.

### Terms of Sale

Originally the Greenberg-Ryan group had offered $570 million but the Crane-Cuban group countered with $582.1 million, though the financing of that amount was not considered totally secure. In the end Greenberg-Ryan got the team, paying $590

7 Disclosure Statement, p. 7
8 Disclosure Statement, p. 4
9 "Chuck Greenberg (businessman)", Wikipedia article
10 AP story Texas Rangers Bankruptcy, May 24, 2010
11 NORTHERN DISTRICT OF TEXAS Case No. 10-43400 (DML)-11
12 AP story Texas Rangers Bankruptcy, May 24, 2010


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million--$385 million in cash at closing and assumption of liabilities estimated at $205 million.[13] For that they acquired all operating assets, player and media contracts, and the minor league franchises too. Also included was an interest in something called "*The Major League Baseball Trust, a Delaware statutory trust owned by the 21 Major League Baseball Clubs that participate in the league wide (finance) facility*…"[14] (emphasis added). Little information is available on this last entity. Basically all leases and executory contracts were assumed by the purchasers.

As to the respect accorded the veto rights of Major League Baseball under the Major League Constitution, the Debtor said the following in the Disclosure Statement: "*The Debtor, as a member of Major League Baseball, is subject to the rules and regulations of MLB. In particular, any sale of the Texas Rangers franchise cannot be consummated without first obtaining the requisite approval from the Commissioner of MLB and 75% of the MLB clubs. The sale of any MLB club must comply with the process set forth in the Major League Constitution and MLB ownership guidelines…*" (emphasis added).

### Conclusion on the Rangers Case

As in the Pittsburgh Penguins sale to the Mario Lemieux group, the sale of the Texas Rangers went to the hometown hero, in this case, Nolan Ryan. In this case it seems there was no threat to move the team to another city. While the pre-pack was intended to speed the process, some have observed it actually seemed to slow the sale process.[15] As with the other major sports bankruptcies, no unrelated party creditor suffered any loss. While there was no major discussion of the veto rights of Major League Baseball by the Judge, the confirmed plan did require MLB approval as a Condition Precedent to the Effective Date.[16]

## LOS ANGELES DODGERS

Tracing its roots back to 1849 and officially named the Brooklyn Dodgers in 1932, the team moved to Los Angeles in 1958. The team has won a total of six World Championship titles. In 1998, Fox Sports purchased the Dodgers from the O'Malley family and created a regional sports network. Thereafter, in November 2001, the Dodgers and Fox Sports entered into a Telecast Rights Agreement. In 2003, Fox Sports decided to sell the team along with the surrounding real estate (stadium and parking lots), and in early 2004, Boston real estate developer Frank McCourt purchased the Dodgers and the associated real estate for $430 million. Almost all of the funds were borrowed. In connection with the purchase, Fox Sports and McCourt agreed to an amendment to the Telecast Rights Agreement. Under the amended agreement, the term of the Telecast Rights Agreement was extended to grant Fox Sports the right to telecast Dodger games through the 2013 season. Furthermore, Fox Sports received an exclusive renegotiation right for an additional five-year term, with negotiations to take place from October 15 to November 30, 2012. Fox also received a right of first refusal as to third-party offers.[17]

As part of the approval of the sale, MLB "required that Mr. McCourt agree to provide an additional $30 million in liquid equity within three years [of acquisition] through the sale of certain real estate assets or by securing equity investors", which was never paid. Under the McCourt ownership, the Dodgers performed well. However, on October 14, 2009, while the Dodgers entered into its second championship series, Frank and Jamie McCourt announced their separation after thirty years of marriage. A few days later, Frank McCourt claimed he owned one hundred percent of the team; Jamie claimed otherwise, stating she held a fifty percent ownership interest. On October 22, 2009, Frank McCourt fired his wife as the Chief Executive Officer of the Dodgers. This action triggered Commissioner Bud Selig to announce that the league would track the McCourts' ongoing and much publicized dispute. Shortly thereafter, on October 27, 2009, Jamie McCourt filed for divorce and spousal support and was awarded more than $7.6 million per year. To cover the spousal support and other financial obligations, McCourt entered into a proposed transaction with Fox Sports, which involved the sale of the Dodgers' future telecast rights. The transaction was reportedly valued at about $1.7 billion in telecast fees, but also involved Fox Sports making a $385 million loan to one of the McCourt-owned entities to pay for the proposed divorce settlement and to satisfy other financial obligations. The telecast rights transaction was subject to MLB approval and required the consent of Jamie McCourt due to her claimed ownership interest in the Dodgers. Meanwhile, the divorce proceedings exposed the McCourts' lavish lifestyle and use of Dodgers funds for personal purposes. On December 7, 2010, the court invalidated the post-nuptial marital agreement that Frank McCourt had claimed provided him with sole ownership of the Dodgers. (Despite this victory, Mrs. McCourt later agreed to a marital settlement of "only" $130 million).[18]

However, it appears that Mr. McCourt had incurred the wrath of the Commissioner and on June 20, 2011, Commissioner Selig advised McCourt by letter that MLB would not approve the proposed Fox transaction. Commissioner Selig declined to approve the transaction for multiple reasons, including: (a) McCourt did not obtain other offers for the telecast rights and, therefore, did not maximize the value of those rights; (b) the loan advance would "hamstring" the Dodgers going forward and would sacrifice the Dodgers' future in exchange for an immediate payoff. Based on Commissioner Selig's refusal to approve the proposed Fox transaction, the Los Angeles Dodgers LLC did not have sufficient funds to meet payroll and other expenses in June 2011. Accordingly, on June 27, 2011, the Los Angeles Dodgers LLC and other debtors negotiated a debtor-in-possession financing commitment and filed for Chapter 11 bankruptcy.[19]

The two largest liabilities listed were compensation owed to Manny Ramirez $20 million and Andruw Jones $11 million. Apparently Mr. McCourt did not immediately meet with the team to explain what was happening and reassure them as happened in the Rangers case. First base coach Davey Lopes complained that

[13] NY Times article, "Texas Rangers Sold at Auction", August 5, 2010 nytimes.com

[14] Disclosure Statement, p. 7

[15] NY Times article, "Texas Rangers Sold at Auction", August 5, 2010 nytimes.com

[16] FOURTH AMENDED PLAN OF REORGANIZATION, p. 26

[17] Most of the history of the Dodgers transaction is taken from an article by John Dillon, Major League Baseball Bankruptcies, published by Loyola Law Review, June 1, 2012

[18] NY Times, Group Led by Magic Johnson Win Auction, March 27, 2012 nytimes.com

[19] In re: LOS ANGELES DODGERS LLC, et al., Case No. 11-12010 (KG), Bankruptcy Court for the District of Delaware

"No one's explained anything to us, which I find a little ironic, for the lack of a better word… Mr. McCourt has not come down to address the players at all. I just don't understand that."[20]

In response to the filing, the Bankruptcy Court in Delaware directed the procedural consolidation and joint administration of the Chapter 11 cases and allowed the debtor entities to continue as debtors-in-possession. Filing a petition further antagonized the Commissioner who sought at one point to terminate the exclusivity privilege of McCourt and the Dodgers so that MLB could file its own plan of reorganization.

There were many maneuvers by the four parties involved: MLB, McCourt and the Dodgers, Mrs. McCourt and Fox Sports. McCourt's basic strategy was to use the bankruptcy proceeding to facilitate the sale of the future TV rights, possibly to someone other than Fox, so that he would have funds to stay in control of the team. MLB vigorously opposed the bankruptcy filing and contended that McCourt was using the bankruptcy as a ploy to avoid preexisting contractual obligations with MLB and Fox Sports. Further, MLB contended that McCourt and the debtor entities could not avoid their obligations by commencing Chapter 11 bankruptcy and that the Bankruptcy Code did not displace MLB's approval rights under the MLB Constitution and other agreements. MLB also contended that the sale of the Dodgers' telecast rights without MLB approval would subject the club to possible termination. The enforceability of the league Constitution was well vetted in the case with MLB making several alternative arguments that the franchise could not be altered or transferred without the league's consent, but in the end, no definitive ruling was made on this overarching issue. The league took the position early on that a sale of the team was the only possible outcome. When the bankruptcy court invalidated Fox Sports' exclusive renegotiation time frame in the telecast agreement and granted the Dodgers' amended motion to market the telecast rights, along with the sale of the team, Fox Sports promptly appealed the bankruptcy court ruling. The U.S. District Court ruled that the bankruptcy court erred in relieving the Dodgers from its contractual obligations under the Fox Sports telecast agreement. This seemed to break the logjam and in January 2012, Fox Sports and the Dodgers settled their dispute. Under the Fox Sports/Dodgers settlement, the Dodgers agreed to abandon its proposed sale of the telecast rights and Fox Sports agreed to withdraw its objections to the settlement between the Dodgers and MLB. As a result, McCourt could proceed with the sale of the Dodgers pursuant to a settlement between the Dodgers and Major League Baseball.

### Auction Process and Terms of Sale

Eleven bidders survived the first round[21] but only three survived the second round—the Magic Johnson group, one led by Stanley Kroenke, billionaire owner of the St. Louis Rams and another led by hedge fund manager Stephen Cohen and pharmaceutical exec Patrick Soon-Shiang. In the end, the Magic Johnson group was the winner, according to one story paying almost $500 million more than the next highest bidder.[22] The winning group, largely financed by Guggenheim partners, includes Stan Kasten, the former president of the Atlanta Braves and Washington Nationals, and Peter Guber, the film producer and head of Mandalay Entertainment. The all-cash bid included $2 billion for the team (minus $412 million in debt) and $150 million to create a joint venture with McCourt on the parking lots and land surrounding Dodger Stadium, thus the deal totaled $2.3 billion. The price was the most ever paid for a professional sports team at the time, superseding the $1.4 billion paid for Manchester United and the $1.15 billion paid for the Miami Dolphins. From the sale proceeds, McCourt was to repay $150 million advanced by Major League Baseball to keep the team going and the $130 million marital settlement to Mrs. McCourt.[23]

### Conclusion on the Dodgers Case

This was a classic example of the owner's financial problems spilling over into the operation of the team. While the enforceability of the league's veto power over team financial operations and the team's right to use bankruptcy was thoroughly briefed, no definitive ruling was made on it. While relocation was not an issue in this case, it does show that the distributor of the local TV rights is another major figure which can come into play in sports bankruptcy cases.

## COMMENTARY

This survey of hockey and baseball bankruptcy cases shows that disruptions to a team's finances can come from both on-field and off-field sources. While the deep-pockets-owner has generally served professional sports well, sometimes the owner has financial or personal troubles which then adversely affect the team. Also, the current environment of large publicly financed stadium leases and lucrative broadcast rights can complicate bankruptcy proceedings. To the credit of the major sports leagues, all unrelated party creditors were paid in full in all cases. No clarity has surfaced on the leagues' claimed power over team finances. There appears to be a delicate dance where bankruptcy courts seem to respect the right of the leagues to veto ownership changes or relocations. On the other hand, the professional leagues are apparently reluctant to exercise the more drastic provisions requiring forfeiture of the franchise itself for noncompliance with league rules.

*Thanks to Larry Aronson, Grant Newton and Dennis Bean for their assistance with this article.*

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20 Article Los Angeles Times, June 27, 2011 latimes.com

21 Wall St. Journal, Dodgers Bidders Prepare to Round Second, Feb. 16, 2012

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# The State of Lower Middle-Market Lending

Private equity firms and independent buyers acquiring companies with $2-5 million of EBITDA have seen an improvement in the lending environment in recent months. Among the numerous factors at play are more intense competition among lenders, either regional banks for the stronger, cleaner deals usually with personal guarantees or highly equitized structures, but also asset-based lenders (ABL) or non-bank cash flow lenders for credits that don't meet traditional bank requirements. It is also important that lower middle-market companies are able to exhibit at least 1-2 years of earnings growth since 2009.

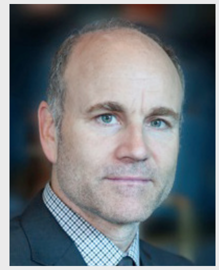
**Competition among lenders**—M&A activity in the lower middle market has gained momentum, while deal volume among larger companies has continued to lag**.** Most M&A professionals are of the view that change of control and dividend recap transactions were pulled forward into 2012 to take advantage of tax benefits, which mostly left Q1 dry; however, investment bankers are working hard to output opportunities and the second half of 2013 is expected to be a very active change of control and recap transaction period. Traditional up-market lenders have lowered their target EBITDA thresholds in order to take advantage of these opportunities and put more capital to work. Banks that have traditionally held an EBITDA minimum of $10 million have been forced to look at deals with $7-8 million of EBITDA or even lower in order to see enough deal volume.

Many banks are also moving down market in order to achieve higher yields in a less efficient market. In our discussions with many lenders, there is a tremendous amount of available debt capital for financings of decent companies with EBITDA above $10 million, and many lenders are coming down into the lower middle-market as it is less efficient and lenders can get yields they are seeking. The entrance of new lenders to the lower middle-market has intensified competition among lenders in a market without dominant players.

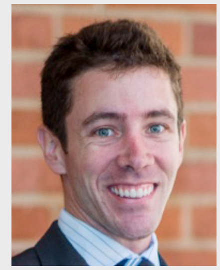
For heavily equitized transactions, most banks are very cooperative to their best PE sponsor clients. More lightly capitalized acquisitions tend to get financed with a combination of ABL (senior collateral-based revolvers and fixed asset term loans) and non-bank debt funds more specialized to lower middle-market cashflow financings with higher yields.

**Earnings stability**—With the Great Recession now 2 years in the rearview mirror, lower middle-market companies have had the runway to recover and exhibit earnings stability, making them much more attractive borrowers than they were in 2009 and 2010 when many had trough earnings. With leaner operations and growth in revenue since 2009, lower middle-market companies are poised to reach the next level in their evolution. With profitability now back in place and seasoned for most businesses, along with

**Matt Thompson, CIRA**



**Britt Terrell**



**Devin Scott**

credit markets being very robust, owners have 'options' for debt financed dividend recaps to pull some chips off the table, or sell at healthy valuation for exit. Admittedly, sellers missed the most advantageous tax window of 2012, but these are still worthy times for a transaction.

## Typical Deal Terms

In the lower middle-market (defined here as businesses with $2-5 million of EBITDA), there are financing sources available for both well-performing and underperforming companies. The amount of equity put into a deal by the investor, greatly impacts the other deal term parameters. Highly equitized transactions tend to get the terms they want from lenders. For lightly equitized transactions, many banks will require personal guaranties, although most borrowers prefer to pay higher interest rates in exchange for no guarantees. Some of the trends in loan deal terms are discussed below.

**Pricing**—Average pricing for lighter capitalized (~0-20% equity), unguaranteed ABL in the lower middle-market ranges, pending on borrower quality, between 6% and 15%. "Senior cash flow" financing that is lightly capitalized is hard to find on an unguaranteed basis, as banks tend to not play here. Non-bank debt funds that are more unitranche / 2nd lien / mezzanine oriented are the main financing sources in this sector, and consequently the cost of funds is higher, depending how deep into the capital structure the debt reaches. Lighter equitized leveraged financings at around 3x EBITDA can be priced as mezzanine in the mid-high teens (some into the 20's including equity warrants). Pricing for more heavily capitalized (~40% equity) deals is ~3.0–4.0% for senior debt, with mezzanine being ~12% cash pay plus 2% PIK accrued interest.

**Unitranche structures**—A unitranche debt structure is a blend of 1st lien senior debt and 2nd lien debt into one credit agreement with either a single or multiple lenders. This debt structure is designed to streamline the financing process and ideally has one agent-lead lender driving all diligence, documents and closing processes. If there are first-out / last-out tranches within the unitranche credit agreement, the intercreditor terms are built in, ideally eliminating intercreditor negotiations. There is a "blended" cost of funds which can range pending capitalization by the sponsor and quality of the business, but pricing ranges between 7.5% and 12%.

**Equity requirements**—The lowest cost lenders will require a traditional ~35-40% equity investment by sponsors. The collateral ABL's and the higher costing non-bank debt funds can fund debt structures with only ~10-20% equity; however, the non-bank 2nd lien lenders may stretch deep enough into capital structure to earn equity warrants.

**Financial covenants**—Covenants may vary, but are typically tested quarterly. Among the most commonly used covenants are minimum EBITDA, maximum total leverage, minimum fixed charge coverage, and maximum capital expenditures. In the lower middle-market, with moderate equity deal structure, Maximum Leverage through senior typically is ~2.5x EBITDA and Maximum Total Leverage through the Mezzanine is ~3.5-4.0x. Minimum Fixed Charge Coverage typically is about 1.2:1.

**Time to close and amount of diligence**—ABL's will do their own collateral audit, which may require appraisals of inventory and fixed assets that are being financed. Cash flow lenders will require a Quality of Earnings report from a specialized due diligence or CPA firm. Once a lender term sheet has been accepted and signed, diligence and legal documentation is about 6 weeks, pending complexities.

**Other buyout structuring elements**—typically seen in thinly sponsored/equitized transactions are (i) seller rollover equity, (ii) seller notes and (iii) contingent seller earnouts. ■

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**MEMBER IN THE NEWS:**

### Eric Kerwood, CIRA, Joins KCC as Director of Corporate Restructuring Services

Eric Kerwood, CIRA, recently joined Kurtzman Carson Consultants, LLC, as a Director of Corporate Restructuring Services in its New York office. Bringing more than fifteen years of financial advisory experience to KCC, Eric will actively participate in the company's business development initiatives and lead key client engagements.

# Negotiating Secured Loan and Restructuring Documents: Watch Out for "Standard Terms"

**Jeffrey M. Pomerance, Esq.**
*SulmeyerKupetz*

Whether in the original negotiation process or in working through restructuring a secured loan, a borrower is at a significant disadvantage even in a "borrower's market." From the commencement of the relationship, a secured lender typically possesses the "power of the pen" in its dealings with its borrowers. Typically, the secured lender will provide a borrower with a term sheet that contains the economic terms of the loan, as well as language that suggests the definitive loan documents will include "standard" provisions consistent with a transaction of this nature. Certainly, the economic terms need to be consistent with the understanding of the parties—the interest rate, costs, fees and charges the secured lender is requiring as part of its lending facility must be acceptable to both parties. In many instances, the parties will negotiate the term sheet to reflect the agreed-upon economic terms of the loan. In too many instances, however, the parties will not address the noneconomic terms, and certainly not the "standard terms" to be included in the definitive loan documents.

Following the term sheet negotiation, a secured lender will, almost without exception, provide a prospective borrower with its form, which sets forth not only the economic terms of the relationship, but also the legal terms upon which the secured lender is willing to extend credit. Often, these initial loan documents are provided to a prospective borrower with the understanding that the noneconomic terms are standard and appropriate for a secured loan transaction, and further that such documents were already approved by the secured lender's lending committee and formed the basis for the underwriting decision to extend credit to the prospective borrower in the first place. This negotiating "disadvantage" is generally even more pronounced in favor of secured lenders when borrowers seek to restructure the original loan documents, even if the terms at issue in the original loan documents are unfair, untenable or have already caused the borrower to be in default thereunder; in such instances, the borrower will be advised that it already accepted these "standard" terms.

## Concerns Relating to Standard Terms

Too often, a borrower's failure to address and negotiate the standard "legalese" in the term sheet and follow-up definitive loan documents can expose a borrower to significant problems, including problems that arise even when the borrower is making timely payments and otherwise doing everything it is required to do under the loan documents. The following are just a few examples of problems that can arise from "standard provisions" in secured loan and restructuring documents:

**1. "No Additional Liens" Covenants**—Secured lenders often include as a "standard" provision a covenant which prohibits a borrower from incurring any additional liens, claims or encumbrances. While on its face this prohibition seems reasonable for the protection of the secured lender, in many instances this prohibition can pose problems for borrowers. Consider the following occurrences, all of which might well be in violation of the prohibition against no additional liens:

(a) Landlords', carriers', warehousemen's, mechanic's, materialmen's, repairmen's or other like liens arising in the ordinary course of business;

(b) Pledges or deposits in the ordinary course of business in connection with workers' compensation, unemployment insurance and other social security legislation, other than any Lien imposed by ERISA;

(c) Deposits to secure the performance of bids, trade contracts and leases (other than Indebtedness), statutory obligations, surety bonds (other than bonds related to judgments or litigation), performance bonds and other obligations of a like nature incurred or arising in the ordinary course of business;

(d) Purchase money security interests in connection with advancement of inventory by suppliers in the ordinary course of business; and

(e) Statutory liens that arise by operation of law. In certain industries, this can be a big problem. For example, borrowers in the agricultural industry routinely face the prospect of addressing statutory liens arising in connection with the Federal Perishable Agricultural Commodities Act ("PACA"), the California's Poultry and Fish Supply Liens and similar California producers' and agricultural-related liens governed by statute.

In all likelihood, the items enumerated above are imperative for most businesses to continue to operate, and, depending upon their terms, may be highly beneficial both to the borrower and its secured lender. In many instances, secured financing, despite its terms and conditions, is the most "inexpensive" source of capital for developing businesses; the economics may require that a borrower move forward with a secured lender committed to including tough provisions. At a minimum, however, borrowers need to know that unless the standard "no liens" provision is modified, the occurrence of any of the above-listed items may result in a borrower being in breach of the original or restructured loan documents, and certainly may significantly hamper a borrower's ability to operate its business.

**2. "No Additional Indebtedness" Covenants—**Secured lenders often include as a "standard" provision a covenant which prohibits borrowers from incurring any additional indebtedness. While on its face this prohibition seems reasonable for the protection of the secured lender, in many instances this prohibition can pose problems for borrowers. Consider the following occurrences, all of which might well be in violation of the prohibition against any additional indebtedness:

(a) Incurring future wages, salaries, consulting fees and deposits incurred in the ordinary course of business;

(b) Buying supplies and materials on credit;

(c) Incurring credit card expenses due in the ordinary course of business;

(d) Incurring payments due in connection with operating leases, licenses and other obligations incurred or otherwise due in the ordinary course of business.

Clearly, the items enumerated above are imperative for businesses to continue to operate. However, unless the standard "no additional indebtedness" provision is modified, the occurrence of any of the above-listed items may result in a borrower being in breach of its loan documents.

In many instances, these standard "no additional indebtedness" covenants generally are unnecessary, and too restrictive. Many secured loan and restructuring documents contain financial covenants, including covenants that prohibit a business from incurring too much debt as a proportion of total assets or current assets. These "ratio" requirements are designed to protect secured lenders by restraining a company from taking on too much debt, and becoming a more risky operation by being "over-leveraged" relative to the borrower's operating assets. Unlike these financial covenants, the standard blanket prohibition on additional indebtedness does not permit businesses from incurring those additional obligations that might be beneficial to the business and which are, relatively, not significant to the financial condition of the company.

**3. "Notice of Default" Covenants**—Secured lenders often include a "standard" provision that, upon the occurrence of certain events, the borrower will be "in default" or "in breach" of the secured loan agreement or restructuring documents. How does a borrower know about the occurrence of certain events which can give rise to a default? In some instances, the language of the documentation itself provides clarity as to what constitutes a default. For example, the documents typically state that a borrower's failure to make a payment by a set date "triggers" a default. However, in many instances, a borrower will not know about the occurrence of certain events which could give rise to an event of default. Naturally, it would make sense from a borrower's perspective to require the secured lender to provide a borrower with a written notice as to the occurrence of events that will result in a breach of the secured loan or restructuring documents. Typically, secured lenders will attempt to avoid this requirement, as they see this as a burden or even a potential delay in their efforts to enforce their rights. While on its face this seems reasonable for the protection of a secured lender, in many instances this prohibition can pose problems for borrowers.

A "default" can cause a borrower both major economic hardships (including the liability for default interest and other charges) and legal problems (including jeopardizing a borrower's collateral as well as a borrower's rights under other agreements which include "cross-default" provisions, making a default under the secured loan or restructuring documents a default under such other agreement). To the extent that the problem can be "fixed" or "cured," advance warning of a potential breach or default may permit a borrower to avoid the costs and problems that generally arise when a secured loan or restructuring agreement goes into default. In addition, if a borrower learns about a potential breach, and determines that, in actuality, the potential breach is not a breach, the borrower can contact the lender in advance, with the goal of working out the difference and potentially avoiding the costs and unpleasantness of a declared default. Of course, absent a "Notice of Default" covenant, a borrower will not be afforded such opportunities.

There are many factors which determine the specific terms and conditions incorporated in secured loan and restructuring documents, including the economy, a borrower's financial history and performance, the type of collateral involved, and in the restructuring context, the type of default that may have previously occurred (giving rise to the restructuring transaction). Typically, a secured lender and a borrower will attempt to hammer out the "economic terms" of the secured loan or restructuring transaction. Unfortunately for the borrower, however, the parties rarely address what is commonly referred to as "standard" legal terms that find their way into final loan and restructuring documents. While a borrower's ability to negotiate these terms may be problematic, too often borrowers are unaware that these standard terms can be problematic and should be negotiated, or at least accounted for, in evaluating any loan or restructuring opportunity. ■

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# Bankruptcy Taxes

**Forrest Lewis, CPA**
*Section Editor*

## MORE ON WHEN COD OCCURS AND THAT PESKY 1099-C

The fallout from the financial crisis continues, recently raising questions about when cancellation of debt (COD) occurs for individual income tax purposes and the relationship to issuance of Internal Revenue Service Form 1099-C by the lender. Generally, Form 1099-C must be issued by a creditor when there is an "identifiable event" signaling that the debt has been canceled plus an arbitrary 36-month "no action" rule adopted by IRS. (A similar form, 1099-A, is issued when collateral is abandoned to the creditor or is repossessed. While 1099-C and 1099-A were originally aimed at slightly different situations, they have converged to have a lot of overlap).

Cancellation of debt is a form of taxable income under Internal Revenue Service Reg. 1.61-12; however, there are certain favorable exclusions in the Internal Revenue Code. The primary relief provision is incurrence of COD in a taxable year when the individual debtor is insolvent but that is only limited to the extent of insolvency.

> *Example 1:* In 2012 individual A's liabilities exceed his assets by $30,000. His delinquent $40,000 loan from Creditor X passes the statute of limitations and can no longer be legally enforced. If A has no other favorable exclusion available to him, he must recognize $10,000 of taxable income in 2012 ($40,000-$30,000).

> *Example 2:* In 2013 individual A's financial situation has improved and he now has $20,000 of net worth. A credit card account on which he has owed $5,000 for several years hits the statute of limitations and the bank issues a Form 1099-C for $5,000. If A has no other favorable exclusion available to him, he must recognize $5,000 of taxable income in 2013.

Other prominent exclusions are for debts discharged in bankruptcy proceedings, certain business real property loans, etc. For 2013, the exclusion for discharge of debt on a "qualified principal residence" has been extended, but at this point it has not been extended for 2014. Thus, timing is very important.

### Events Indicating Discharge

Generally, the courts have determined that cancellation of debt has to be recognized upon an "identifiable event" which indicates the debt is worthless, the creditor has given up on collection or the debt can no longer be enforced. The following have been ruled to be "identifiable events":

- Discharge of indebtedness under title 11 of the United States Code (bankruptcy);
- Cancellation or extinguishment of an indebtedness that renders a debt unenforceable in a receivership, foreclosure, or similar proceeding in a federal or State court;
- Cancellation or extinguishment of an indebtedness upon the expiration of the statute of limitations for collection of an indebtedness or upon the expiration of a statutory period for filing a claim or commencing a deficiency judgment proceeding;
- Cancellation or extinguishment of an indebtedness pursuant to an election of foreclosure remedies by a creditor that statutorily extinguishes or bars the creditor's right to pursue collection of the indebtedness;
- Cancellation or extinguishment of an indebtedness that renders a debt unenforceable pursuant to a probate or similar proceeding;
- Discharge of indebtedness pursuant to an agreement between a creditor and a debtor to discharge indebtedness at less than full consideration;
- Discharge of indebtedness pursuant to a decision by the creditor, or the application of a defined policy of the creditor, to discontinue collection activity and discharge the debt.

In addition, the IRS instructions to Form 1099-C contain another condition which does not fit the traditional "identifiable events" which involve legal impossibility of collecting a debt: the expiration of a 36 month non-payment testing period. This event occurs when the creditor has not received a payment on the debt during the a 36-month period ending on December 31, plus any time when the creditor was precluded from collection activity by a stay in bankruptcy or similar bar under state or local law.

### Inside the Financial Institution

In a recent ABA tax listserv thread, one former bank loan officer gave the banker's perspective on a specific situation in which the 36 months ran and the 1099-C was issued. The loan officer probably knew enough of the borrower's situation to realize that the loan was not collectible so made no overt collection efforts and it may have been written off for financial accounting purposes early on. However, the loan officer has no incentive to issue the 1099-C because he may hold out some hope the loan will be repaid and there is a concern that issuing the 1099-C will prevent the bank from continuing to attempt to collect (see article below on the W. S. Reed case). He probably reviews it every six months or so unbeknownst to the customer. After 36 months with no response, the bank issues the 1099-C. The point of his post is that the bank has little motivation to make a considered decision on when it gives up on the loan and when the 1099-C should be issued. But, as explained above, timing makes a big difference to the individual debtor.

### Commentary

In assisting individual clients in dealing with the tax effects of a 1099-C, a tax adviser should consider whether the timing of the 1099-C is correct and the amount is accurate. It may be possible to assert that the debt was discharged in a year that is better for the client in terms of available exclusions under Section 108 or available deductions and credits on the client's return. There are a number of low level cases in which the Tax Court has ruled that the 1099-C was issued for the wrong year or that reduce the amount of the debt that was discharged. A recent case is Kleiber, TC Memo 2011-233, and there are many similar small tax case division cases. Of course, if an adviser believes a 1099-C is in the wrong year or in the wrong amount, it is important to include the amount of the 1099-C in gross income for the year for which it is issued on the individual tax return and then take a deduction to correct it with an appropriate explanation. It is never wise to just ignore a 1099-C.

See http://www.irs.gov/pub/irs-pdf/i1099ac.pdf

*Thanks to attorney Katherine Lewis, Grant Newton and Dennis Bean for their assistance with this article.*

## MINORITY DECISION IN *W. S. REED*: 1099-C ESTOPS FINANCIAL INSTITUTION FROM PURSUING COLLECTION

While numerous decisions have held that issuance of a Form 1099-C for cancellation of debt does not prevent a financial institution from pursuing collection of a debt, a recent Tennessee bankruptcy court decision holds that it does (*In re William Stanley Reed, Debbie Elaine Reed, Debtors*., U.S. Bankruptcy Court, E.D. Tennessee, 12-30049, May 14, 2013).

As discussed in the article above, a financial institution must issue a Form 1099-C reporting to IRS when a debt is discharged according to certain "identifiable events," mostly relating to legal prohibitions on collection, compromise of the debt or a charge off in accordance with the institution's bad debt and collection policy. In this case, the court held in a long, complicated opinion, which the deciding judge admits is a minority position, that it was "inequitable" for the financial institution to both cause the debtor to pay tax on the loan deficiency and still pursue collection. It was objectionable in this case because the bank unilaterally issued the 1099-C for a $5,000 deficiency one month after foreclosing on a $262,000 parcel of property; the remaining principal balance had been $267,000. The event which triggered the 1099-C was not the arbitrary 36-month "no action" period after which the IRS forces a financial institution to issue a 1099-C. When the debtors filed a Chapter 13 petition to thwart a collection proceeding by the bank, the bank filed a claim in the Chapter 13 case. Even though the IRS takes the position that issuance of a 1099-C does not forestall a financial institution from pursuing collection, the judge felt the claim was inequitable and disallowed the claim.

## AT LAST, IRS PRODUCES BENEFICIAL SUBSIDIARY SALE REG - 27 YEARS LATER

In 1986 Congress changed the tax law to cause corporations to recognize tax in many situations involving sale or distribution of appreciated assets. This change was known as the "repeal of the General Utilities doctrine" after a famous old case. Generally the change reinforced the "double taxation" inherent in C corporations (regular taxable corporations). In the process, Congress allowed two relief provisions from double taxation, one was known as "338(h)(10)" which permits the sale of corporate stock in three limited situations to be treated as a sale of the underlying assets for tax purposes but maintains the integrity of the corporate charter, thus facilitating retention of favorable loan covenants, property tax classifications and licenses, etc., held by the corporation. Asset sale treatment increases the tax basis in the underlying assets consistent with the fair market value purchase price the buyer paid for the corporate stock, so a taxable gain is only recognized on the "asset sale" portion of the transaction, there is no gain on the "stock sale" portion. Thus, there is only one level of tax. The other relief provision was known as "336(e)" which similarly permits a sale or distribution of corporate stock to be treated as an asset sale for tax purposes while maintaining the integrity of the corporate shell. This latter recently became effective May 15, 2013 with the finalization of IRS regulations on this section. [T. D. 9619 implementing Regs. 1.336-1 et. seq.]

### 338(h)(10) Sale

As described in an article in this column in 2011 (Vol. 25, number 2), under this provision deemed asset sale treatment is allowed for sales by consolidated groups of corporations, affiliated groups of corporations and by S corps. In the case of the consolidated groups and the S corps, the Congress was not really giving much away as they are both "pass through" type entities where a sale of the underlying assets would have increased the basis of the selling corporation in the hands of its shareholders so that there would be only one tax on sale anyway. The ability of an affiliated corporation (an 80% owned subsidiary not subject to a consolidated group tax election) does truly eliminate a second level of tax. The main feature of all three is that it makes it very convenient for the buyers by allowing them to keep the corporate shell and all its contracts, permits, licenses, etc. intact. This provision has a wider application than 336(e) and the regulations on it were issued in 1994.

**336(e) Sale or Distribution**

After 27 years, the Internal Revenue Service finally got around to finalizing regulations implementing this provision. The rules under 336(e) are very similar to those under 338(h)(10) and in fact there is a case in which they overlap and the new regs say in that event the much more evolved rules under 338(h)(10) govern. Thus, if we eliminate the more common cases in which a subsidiary or an S corp is sold to a corporate buyer, what situations does 336(e) apply to? While the regs are new and yet to be fully digested, these three situations seem to stand out:

1. Sales which do not qualify for 338(h)(10)—Under the latter rules, only a corporation is allowed to be a buyer. But 336(e) applies to individual buyers, and presumably partnership, trust, etc. buyers as well. This greatly widens the application of the relief provisions. If corporation M owns 100% of the stock of corporation N which has basis of $600,000 in its assets and M sells the stock of N to Individual A for $1 million, an election can be made to treat the sale as if the assets of N were sold for $1 million, resulting in a step up in basis of the N assets to $1 million. Individual A now has "outside basis" of $1 million in the N stock and N has "inside basis" of $1 million in its assets.
2. Distributions—dividend or liquidating distributions of subsidiary stock to shareholders of an intermediate corporation. For example, if Corporation P, which owns 100% of the stock of Corporation Q, distributes the Q stock to the P shareholders, be they individuals, corporations, etc., an election can be made to step up the basis of the assets of Q. Those rules are beyond the scope of this article and will not be discussed further here.
3. Disqualified spin offs—Under Sec. 355, in the case of spin offs of corporations in which the Distributing or Distributed corporation undergoes a change of ownership within 2 years, the normally tax free treatment of the spin off is disallowed. In that case, the Distributing corporation pays a tax based on the fair market value of the assets less the corporation's tax basis in those assets. As a matter of tax fairness, the new rules will allow an election to step up the basis in the underlying assets. Those rules are beyond the scope of this article and will not be discussed further here.

**The 80% Requirement**

A "qualified stock disposition" is a transaction or series of transactions in which 80% by vote and value of the target stock is either sold, exchanged, or distributed, or any combination thereof in a disposition treated as a fully taxable sale, i.e. cannot be a nontaxable transaction such as a corporate reorganization under Sec. 368. Section 336(e) does not require the seller to dispose of all of its target stock, but only enough target stock to meet the 80% requirement. As a result, the seller or a member of the seller's consolidated group may retain some target stock. Further, the final regulations permit the amounts of target stock sold, exchanged, or distributed by consolidated group members to be aggregated for purposes of determining whether there has been a qualified stock disposition. However, sales to a related party do not qualify.

**Calculation of Gain**

The taxable gain is generally computed by adding the selling price for the stock to the amount of corporate liabilities. This is known as ADADP, the adjusted deemed asset disposition price. A simple example:

> Corporation S sells its 100% owned subsidiary T to Individual B on February 1, 2014. They agree in writing to make a 336(e) deemed asset sale election but keep T's corporate charter intact. T has one asset, a parcel of land with a tax basis of $450,000 and a value of $500,000 which is subject to a mortgage of $400,000. Corporation S has tax basis in the T stock of $50,000. Individual B pays $100,000 for the T stock. The deemed selling price (ADADP) is $100,000 +$400,000= $500,000. Corporation T pays corporate tax on a gain of $50,000 (ADADP of $500,000 − asset basis in the land of $450,000). Individual B has basis of $500,000 in the T stock and T has basis of $500,000 in the land.

**Making the Election**

In order to make a section 336(e) election, seller(s), or in the case of an S corporation target, all of the S corporation shareholders and target must enter into a written, binding agreement to make a section 336(e) election and a section 336(e) election statement must be attached to the relevant return(s). If seller(s) and target are members of a consolidated group, the election statement is filed on a timely filed consolidated return and the common parent of the consolidated group must provide a copy of the section 336(e) election statement to target on or before the due date (including extensions) of the consolidated group's consolidated Federal income tax return. If target is an S corporation, the election statement is filed on the S corporation's timely filed return. If seller and target are members of an affiliated group but do not join in the filing of a consolidated return, the election statement is filed with both seller's and target's timely filed returns. Note that the sale causes the tax year of the target to terminate, so that there is a short year return requirement. Form 8883 should be filed to allocate asset basis and in fact, IRS may amend that form to incorporate the 336(e) election.

### Commentary

It is incomprehensible that it took the IRS 27 years to get around to issuing these regulations. In "closely held" companies, this election will primarily be beneficial where there are individual buyers who want to keep the corporate shell intact but get a basis step up in the underlying assets. In large corporations, the election will also be beneficial in some cases where corporate stock is distributed as a dividend or in liquidation and in the rare case of a disqualified, taxable spin off. In all cases, the benefits inure to the buyers, so sellers will want to get paid additional sales price to compensate for the inconvenience and any additional tax incurred.

*Thanks to Grant Newton, Dennis Bean and Joshua Elliott for their assistance with this article.*

## RECENT TAX CASE

### IRS Drops Appeal in Ralph's Grocery

The final chapter has been written in the twenty year old Ralph's Grocery saga with the IRS dropping its appeal. In this case Ralph's Grocery, a small part of the Allied and Federated Stores bankruptcy, was restructured, ostensibly in a taxable transaction under Internal Revenue Code Section 338(h)(10) to obtain a basis step in the assets. It became one of those cases where the IRS got on the "wrong side" and argued that it was actually a nontaxable reorganization under Section 368, probably under Type G, the bankruptcy reorganization. At stake for Kroger was millions of dollars in additional depreciation deductions. According to one report, the now abated IRS tax assessment was $567 million.[1]

An article on the original court case appeared in this column in the April/May 2011 issue (Volume 25, issue 1). While the Tax Court ruled that a taxable sale had taken place, the IRS had argued that some old cases including Alabama Asphaltic stood for the proposition that a bankrupt company's creditors really own it, so that any subsequent transfer to them is not a sale to an unrelated party permitting a step up in basis. When the court ruled that the facts in Ralph's Grocery were different than those in Alabama Asphaltic, one possible result is that in order for future Type G nontaxable reorganizations to be upheld, they must mimic the facts in Alabama Asphaltic. In that case the creditors committee basically took over management of the company even before it went into bankruptcy. It remains to be seen if that interpretation pervades or is a legal dead end like the IRS pursuit of this case. ■

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1 BNA Daily Tax Reports, Nov. 29, 2012

# Bankruptcy Cases

## Supreme Court Takes Case That Will Directly Impact CFPB, FDIC

**Professor Baxter Dunaway**
*Section Editor*

The Consumer Financial Protection Bureau[1] – which oversees regulations for mortgages and other credit products – and a major bank regulator will be closely watching the Supreme Court this fall 2013, Marketwatch.com reported on Tuesday, June 25, 2013. The Supreme Court on June 24 decided to hear *Noel Canning v. NLRB* , --- S.Ct. ----, 2013 WL 1774240 (U.S.), 81 USLW 3629, about whether the White House recess appointments for the labor board violated the Constitution. The Court's decision on the case will also impact the appointment of Richard Cordray, who directs the CFPB, since he was installed at the bureau in the same controversial way as the NLRB nominees. All this means that the consumer bureau's existing rules for mortgages and future rules could be in doubt. Without Cordray, the bureau won't be able to write or enforce rules on many mortgage lenders, payday lenders, credit-reporting bureaus and debt collectors. However, it could still enforce existing consumer laws on many banks and credit card companies. Cordray is also a Democratic member of the five-person bipartisan Federal Deposit Insurance Corp. A decision by the court to invalidate the NLRB nominations could also impact the validity of any big bank capital rules that Cordray votes to approve as a member of the bank regulator. The D.C. Circuit ruled in January that President Obama lacked the power to make recess appointments without Senate consent. The NLRB appealed that ruling in March. The litigation battle comes after Cordray and the NLRB board nominees cannot win the 60 votes needed to be approved by the Senate over the past couple of years.

Supreme Court of the United States

NLRB V. NOEL CANNING, ET AL.

No. 12-1281.

June 24, 2013.

*1 The petition for a writ of certiorari is granted. In addition to the questions presented by the petition, the parties are directed to brief and argue the following question: Whether the President's recess-appointment power may be exercised when the Senate is convening every three days in pro forma sessions.

U.S., 2013.

N.L.R.B. v. Noel Canning

--- S.Ct. ----, 2013 WL 1774240 (U.S.), 81 USLW 3629 ■

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1 For more information about the CFPB, *see* "The Consumer Financial Protection Bureau" in *AIRA Journal,* Vol 26: No.2,2013, pp. 6-9. Available at http://www.aira.org/journal

***Majestic*** *continued from p. 1*

residency status, as well as number of shareholders and other criteria. This is an opportunity bestowed to those who chose to conform to strict shareholder restrictions. The *Trans-Lines West* case has a fundamental misunderstanding of the foundation and utilization of the S corporation. The court viewed it as a burden to the shareholders in that they would accept personal tax liability rather than the corporation. Therefore they concluded that if shareholders elect to bear the brunt of the taxes that they should control their own destiny. Their premise is lopsided and ignoring the shareholder benefit of avoiding double taxation. The S election allows the shareholder to have one level of tax versus having their corporation be taxed as well as themselves when they take the profits out as dividends.

This is not a burden on the shareholder but as stated in *Trans-Lines West* a "right bestowed" by 28 USC §1361 to avoid double taxation and spur the economy with tax incentives for small entrepreneurs. I could proffer the reason why the code has the shareholders determine the election is because it is them who must meet specific guidelines, not just that they bear the burden. As stated in *Trans-Lines West* once they made the election and met those restrictions, S corporation status becomes an intrinsic part and fundamental right of the corporation. I think that a good comparison is to a tax attribute like accounting methods such as using the cash method versus the accrual method which is deemed an asset of the estate via 28 U.S.C. §1398.

A significant portion of the Third Circuit's opinion in *Majestic* focused on a U.S. Supreme Court ruling in *Segal v. Rochelle (382 US 375).* In that case the court ruled that net operating losses (NOLs) were an asset of the estate thereby giving the trustee the right to reverse an NOL carry-back election made by the debtor. Since prior cases equated the S election to NOLs in that it is an asset of the estate, the *Majestic* case went to length to delineate why NOL's are different than an S election. *Majestic* took a narrow approach and argued NOL's are different than the S election because a debtor in possession of NOLs has a defined amount of them at the time of the bankruptcy filing; they are a function of the debtor's operations prior to bankruptcy and are not subject either to revocation by the shareholders or termination by the IRS. Furthermore they compared the intrinsic monetary value of an NOL to the S election which has no quantitative value. They also argued the shareholders of an S corporation can terminate its pass-through status at will, regardless of how long it has been an S corporation and whatever its pre-bankruptcy operating history has been. And finally the tax status of the entity is entirely contingent on the will of the shareholders. To me these are all differences but not determinative factors for our issue.

I believe the *Majestic* case is not looking at the big picture. In a broad but very true sense the S election embodies the NOL's of the company and is a function of the Debtor's prior operations. In a typical corporation the NOLs are an asset which can be utilized against future income and will necessarily follow that income either back or forward. Similarly, in regards to the S corporation scenario the losses flowed to the shareholders and income should follow those losses. It is fundamental to me that the S election is more like a method of accounting which requires a matching of income and expense items much like the accrual basis of accounting. There is a need to match the company losses to the resulting income. The NOL analysis is in essence the same as the S corporation election analysis in a practical sense and the prior courts understood this.

The result of this ruling is that a shareholder of an S corporation in the Third Circuit can now free himself of any potential phantom income and conversely saddle the debtor with any tax consequences. For the debtor this is a major blow to its reorganization as well as a weight on the creditors who will now be required to carry the brunt of the tax burden. All income to the estate will now be taxed to the S corporation without the benefit of any loss carryovers. Furthermore a Trustee who tries to administer an S corporation will probably not be privy to the shareholders purposefully or mistakenly revoking the S election. The Trustee will not even know until the following year when the IRS informs him that the debtor was a C corporation and now owes a lot of tax as well as penalties and interest.

In the vast majority of corporate bankruptcy cases there are significant losses that have been incurred. A major benefit for the standard C corporation debtor and its reorganization is the utilization of these losses to offset the future income. Under the S corporation tax regime these losses flow thru to the shareholders. The shareholders have reaped the benefits of these losses by offsetting other income. However, in most cases these ongoing losses have been suspended for the shareholder because of the at-risk rules. The shareholder has no benefit from the losses until he either lends money directly to the S corporation or alternatively if there is future income from the corporation. The losses generally have been generated through spending the creditors' money and are now suspended.

Although in the *Majestic* case the shareholders were going to bear the brunt of the tax, their case was in all probability an anomaly since the S corporation was a QSub making it a disregarded entity. I believe under the vast majority of bankruptcy cases the result of the *Majestic* ruling will be that the shareholders will be left holding losses they will never benefit from and the S corporation (i.e. newly taxed C corporation) will be paying unnecessary taxes on income due to the deflection of the losses to the shareholders. This creates a significant mismatch of the income and losses of the estate. Furthermore, in *Majestic* the Parent company probably benefited for many years from the losses of their QSub using the Parent's basis to allow utilization of the QSub losses. It is not equitable for them to have taken all the benefits of the losses and stick their creditors with the tax burden. The estate should be permitted to retain the same tax regime to maintain consistency and equity.

With this in mind we can properly respond to the arguments made by the *Majestic* court. The S election issue is the same as the NOL's of the corporation in that we want to match the NOLs of the S corporation against its income. The *Majestic* case argued the S election was "property" of the shareholders since they had the ability to make the election. This was the position adopted from *Trans-Lines West.* Other prior courts understood the above issue I have delineated and properly made the S election comparison to the NOL carry-back election.

The *Majestic* court strayed from *Trans–Line West* and its line of cases and where they conclude that S corporation status is a "right" that is "guaranteed" under the I.R.C." The *Majestic* court responded regarding this position that it …"reflects an incomplete and inaccurate understanding of the law. The I.R.C. does not, and cannot, guarantee a corporation's right to S-corp status, because the corporation's shareholders may elect to revoke that status "at will." The *Majestic* court's reading of this is overly narrow. I view the S election more like a method of accounting which upon the shareholders meeting the requisite criteria can avail themselves of the benefits. They then take on the flow through taxation model similar to any other basis of accounting such as a cash basis versus accrual basis. Just like the accrual method of accounting is consistent on matching the accrued items of income and expense so too the pass through regime is a matching of the costs and benefits of the activity of the corporation and we should be able to have the corporation income follow the losses to the shareholders.

Additionally the *Majestic* court addresses the catch all definition of property used by many courts "We must consider the purposes animating the Bankruptcy Code ... [and] Congress' intention to bring anything of value that the debtors have into the estate."; *Bakersfield Westar*, 226 B.R. at 234." The *Majestic* court argues "tax classification over which the debtor has no control is not a "legal or equitable interest of the debtor in property for purposes of § 541." Once again I need to differ from the *Majestic* court in that this is not a fair representation of prior case law. In this case the tax classification may be argued to be an asset of the estate and is certainly of very significant value and should play a major role in the reorganization of the estate. Here the losses are of significant intrinsic value to the estate and the income should follow the shareholders who have control of those losses thereby matching the income with the losses. In fact in the majority of the cases the shareholders will not be any worse off for maintaining the S status due to loss carryovers yet they may still wish to revoke the election merely to be extra careful.

Perhaps the most backward argument of the *Majestic* court is the final plea for equity in citing the inequities of having the S election enforced. "Finally, aside from their flawed reasoning, *Trans–Lines West* and its progeny (and the Bankruptcy Court's decision in this case) also produce substantial inequities. Taxes are typically borne and paid by those who derive some benefit from the income. Cf. I.R.C. § 1 (imposing taxes on "the taxable income" of the parties listed in that section). As the IRS observes in its brief, "[i]n the typical case where an S corporation or Q-sub receives income, the shareholder has the ability to extract the income from the corporation in order to pay the taxes due on that income." This is an obvious misunderstanding of the reality of these bankruptcy cases. Not being privy to the all the facts of the *Majestic* case I would venture to say the parent corporation reaped significant benefits over the years from the losses generated from the Qsub election. In the standard S corporation bankruptcy case the shareholders will have suspended losses with no future benefit while the Creditors will be stuck with the burden of the taxes without the losses to offset them. This final plea of the court is truly in the face of all reason and equity. If phantom income is generated from the estate the shareholders should have losses to offset them. If they do not, it is only because they have had years of tax benefits at the expense of the creditors.

Finally this case creates great uncertainty for the bankruptcy trustee. Pursuant to *Majestic* the shareholders can reverse the S election at anytime. The trustee will not be privy to this and may be liquidating assets which can cause a tax burden exceeding the benefit. The trustee will not know that he is creating a large tax burden in the estate. The trustee may have tax liabilities that he will not be aware of until 6 months after filing his S corporation return when he is informed by the IRS that they no longer qualify. This would subject to the estate to not only additional taxes but interest and penalties as well. There will need to be a mechanism whereby the trustee will be notified by the IRS of such a revocation.

For the reasons delineated above as well as a rich history of case law within the bankruptcy courts, I would dissuade the other Circuits from adopting this new line of thinking. I welcome varying views of these issues and look forward to comments. ■

*I would like to give credit to Abba Moshe Barer, an associate with my firm, for assisting with this article; and to Professor Fred B. Brown, University of Baltimore School of Law, for proofreading the article and helping to tie things together.*

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