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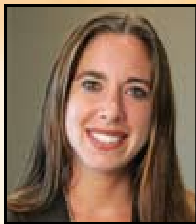

Settlements of Estate Claims: May a Debtor Unilaterally Settle Claims and Causes of Action Commenced by a Creditors' Committee Without the Committee's Consent?

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Introduction

The primary purpose of a compromise or settlement is to avoid the necessity of determining sharply contested and uncertain issues. In the bankruptcy world, where estate resources are limited, if not non-existent, settlements are even more encouraged. Ideally, a debtor-in-possession wishing to have a bankruptcy court bless a settlement should do so with the consent of the major constituents of the Chapter 11 proceedings, including the creditors' committee.[1] Often times, however, a debtor seeks to approve a contentious settlement that is not supported by the creditors' committee or the creditor body. A debtor may try to settle a matter that is so significant that it will have the effect of resolving the Chapter 11 proceedings without satisfying the Bankruptcy Code's confirmation standards. In the context of a Chapter 11 plan, a debtor may even seek to settle an action that was commenced by a party other than the debtor, such as by a creditors' committee, since, on its face, Section 1123(b)(3)(A) of the Bankruptcy Code provides that a plan may provide for the "settlement or adjustment of any claim or interest belonging to the debtor or to the estate." Creditors' committees who are authorized to commence actions on behalf of an estate generally do so as "estate representatives," whereby the underlying claims and causes of action, although prosecuted by the committee, belong to the estate.[2] Thus, on its face, Section 1123(b)(3)(A) seems to suggest that a debtor can, assuming it satisfies the standards to approve a settlement under Rule 9019 of the Federal Rules of Bankruptcy Procedure, settle an action that was commenced by a non-debtor third party, such as a creditors' committee, with or without that party's consent. Such a result poses a number of problems. First, such a result appears to directly contravene the purposes and rulings of various circuit decisions, including *STN*, *Commodore*, *Housecraft*, and *Cybergenics*, all which confirm that a creditors' committee may be granted standing and the authority to bring derivative avoidance actions on behalf of a debtor's estate. Such authorization would be rendered meaningless if a debtor could settle any action commenced by a creditors' committee without the committee's consent by merely satisfying the Rule 9019 standards. Moreover, there would be little incentive for a creditors' committee to go through the hurdles of conducting an in-depth investigation and analysis of possible claims and causes of action and then obtaining authorization from the bankruptcy court to commence such claims and causes of action, only to have such actions be settled by a party that was not even privy to the litigation in the first instance. Thus, to say that a creditors' committee can, after obtaining authorization

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1 Although the proponent of a settlement can include parties other than a debtor-in-possession, such as a Chapter 11 or 7 trustee or a creditors' committee, this article focuses on those situations whereby the settlement is proposed by the debtor.

2 In the Second Circuit, as well as other circuits, a creditors' committee may obtain standing to commence certain claims and causes of action in the name of a debtor-in-possession where (a) the debtor unjustifiably refuses to bring such suit, *see In re STN Enterprises*, 779 F.2d 901 (2d Cir. 1985) ("*STN*") or (b) the creditors' committee has the consent of the debtor-in-possession and the bankruptcy court finds that suit by the committee is (i) in the best interests of the bankruptcy estate and (ii) is necessary and beneficial to the fair and efficient resolution of the bankruptcy proceedings. *See In re Commodore Intern. Ltd.*, 262 F.3d 96 (2d Cir. 2001) ("*Commodore*"); *see also In re Housecraft Industries USA, Inc.*, 310 F.3d 64 (2d Cir. 2002) ("*Housecraft*"); *The Official Committee of Unsecured Creditors of Cybergenics Corp. v. Chinery (In re Cybergenics Corp.)*, 330 F.3d 548 (3d Cir. 2003) ("*Cybergenics*").

In This Issue

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Letter from the President

Grant T. Stein
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Over the past several columns I have discussed AIG, Baer Stearns, Lehman Brothers, Freddie Mac, Fannie Mae, Washington Mutual, the sale of Wachovia, the auto bailouts which are now turning into the auto bankruptcies, and Bernie Madoff. We can add the General Growth Properties, Inc. bankruptcy filings to the list of recent significant developments as this is the first of the its kind which may test the separateness of the owning entities in practice, not theory.

One of the realities of current practice is that not all business can be reorganized and not all going concern value can be preserved. The paradigm of ready buyers being willing to invest in a company through a Section 363 sale, and others being willing to provide debtor in possession financing, has rapidly become the exception, not the rule. In some the recent cases the extreme pressure Courts are under to find ways to provide financial lifelines has breathed new life into the old practice of *cross collateralization*, in the context of a *roll over*, which is being allowed to be used to enable DIP lenders, willing to put their money where their money already is, to obtain a post-petition seniority for their old money.

These issues are going to be addressed as part of the AIRA's Annual Breakfast at the National Conference of Bankruptcy Judges in October, 2009. The Breakfast Panel will discuss *turning the lights out when the party's over.* The use of various approaches to closing a business including bankruptcy, assignments for the benefit of creditors, self-directed liquidations, and simply shutting the doors, will be explored by an experienced and outstanding group of professionals. Consistent with the parallel track at the AIRA Annual Seminar on the *Small Business – Middle Market,* this practical program will address what many of us are really dealing with on a day to day basis.

In the interest of full disclosure, the idea for this program was procured (without fee) from Thomas Moers Mayer of Kramer Levin Naftalis & Frankel LLP in New York. A special thanks is due Tom for his engaging and vibrant intellect, and willingness to share it with the AIRA.

Grant T. Stein

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

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

Executive Director's Column

Grant W. Newton, CIRA
AIRA

UAW Unsecured Claims Receive Priority Over Secured Claims of Teachers and Police

As far as I have been able to determine from the Chrysler plan initially negotiated by the Obama Administration (Chrysler was apparently not a significant part of the negotiations), the UAW will receive a new note for $4.5 billion and 55 percent of the equity interest in the New Chrysler for a general unsecured claim of approximately $10 billion. In addition, 20 percent will go to Fiat, one of Chrysler's competitors, in exchange for granting New Chrysler access to its small car technology. Fiat made no cash payments for the interest and has the right to acquire over 50 percent ownership. The Treasury Department will receive an eight percent interest in New Chrysler in exchange for DIP and exit financing of $8 billion, with claims that appear to be junior to those of the Secured Creditors. Likewise the Canadian government will provide $800 million for two percent ownership in New Chrysler. Although Fiat cannot obtain majority control of the company until after all U.S. government loans have been completely repaid, Fiat can earn an additional 15 percent ownership of New Chrysler by bringing a 40 mpg vehicle platform to New Chrysler to be produced in the U.S.; by providing Chrysler with a fuel-efficient engine family to be produced in the U.S. for use in Chrysler vehicles; and by providing Chrysler access to its global distribution network to facilitate export of Chrysler vehicles. Secured claim holders were offered $2 billion for claims of $6.9 billion.

The New York Times (April 30, 2009) reported that President Obama with a hint of anger railed against the holdout lenders, now effectively a hostile group of business partners, whom he called "speculators." President Obama was quoted as stating about the secured creditors, among them several hedge funds and boutique investment funds, "They were hoping that everybody else would make sacrifices, and they would have to make none," and further noted, "I don't stand with them."

As it turns out only approximately four percent of the fund was held by hedge funds and short sellers. A small interest was also held by the Indiana Pensioners (Indiana Teachers Retirement Fund, the Indiana State Police Fund, and Major Moves Construction Fund) as revealed in the motion filed by the Indiana Pensioners in the bankruptcy court and to be heard in the District Court. The Indiana Pensioners are first lien secured creditors who hold liens on substantially all of the Debtors' U.S. assets, including their plants, equipment inventory and bank accounts, and approximately 65% of the Debtors' equity interests in their foreign subsidiaries.

The position taken by the Indiana Pensioners is that the adoption of a sale plan in the bankruptcy court violates the most fundamental principles of creditor rights – that first tier secured creditors have absolute priority, including over junior and unsecured creditors. As pointed out in the Motion, under the plan the secured lenders receive only 29% of their claims, while providing par recovery to certain unsecured creditors. The sale transfers all Collateral with any value to New Chrysler and then divides the majority of that value among unsecured creditors (the United Auto Workers) and third parties (the US Treasury Department and Fiat).

In the proposed Chrysler restructuring, the loss by Indiana's State Police Fund and Major Moves Construction Fund, which finances roads and bridges, together is estimated to be more than $1 million and the Teacher's Retirement Fund loss was estimated to be at least $4.6 million.

The administration has attempted to justify the bold action that has been taken with banks, and now with Chrysler and most likely GM, as necessary under the circumstances; however, in the process some basic financial and legal principles have been violated. Two basic concepts are summarized in the following questions: Does the fact that TARP funds make banks and bondholders unnecessary to the manufacture of automobiles justify setting aside the rights of creditors? Does President Obama's Administration (the Executive Branch) have the right to change the priorities specified in the Bankruptcy Code (the Legislative Branch)? These issues represent new priorities at the center of national economic strategy that need to be vetted and have their day in court. The insecurity and turmoil of extraordinary times have too often precipitated action without adequate scrutiny and reasoned processes that would allow sounder decisions to be crafted and put into effect.

I have a feeling the atmosphere will be supercharged in Orlando June 10-13; hope to see you there for a very vital and exciting 25th Annual Conference.

Best regards,

Grant

AIRA Scholar in Residence

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

BANKRUPTCY RETAKES

Legislative Musings and the Saga of Bankruptcy Reform

As a senior in Broken Bow High School, I recall being taught that each Presidential Administration seeks to remake America in its own image. Likes so much else from high school, I quickly forgot it. Recent events have conjured up that memory. At least in my professional experience, I have not seen so much Administration and Congressional time devoted to such a broad swath of bankruptcy and financial distress issues. These issues include retail bankruptcy reform, chapter 13 mortgage reform, credit card reform, trustee compensation, bankruptcy issues related to sports franchise failures, the Detroit Three, and "too big to fail" companies in bankruptcy. The folks that I have met in the Administration and Congress are working in good faith, with earnest, in seeking change, in some instances, in fundamental ways. I may happen to disagree with their new goals, often in fundamental ways; nonetheless, I applaud their passion and resolve. I would like to introduce just a couple of the things that are happening on the legislative front. I would be most interested in your feedback on these and ay other topics related to needed legislation in the worlds of bankruptcy and financial distress.

I have previously written about the changes that Congress is seeking in retail bankruptcies. These changes include repealing the 210-day cap regarding assuming or rejecting leases, the section 503(b)(9) claims, the cap on the period of exclusivity, and the increased protections for utilities. In my humble opinion, I believe these changes have a better than even chance in happening.

Congress has also considered providing, for the first time, a bankruptcy judge the discretion to modify primary home mortgages in a chapter 13 case. Reasonable minds could disagree over the merits and demerits of these proposals – that discussion is for another day. My take, however, is that this legislation is going nowhere this term. The Senate has effectively killed the bill.

Congress has further failed to move an important bill forward. This bill would provide an increase in the fee received by the bankruptcy trustee. More than any other, I strongly believe this bill most move forward to ensure the institutional integrity of the bankruptcy system.

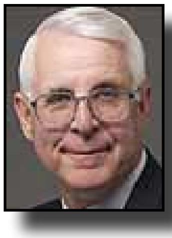
The fee that I am referring to is the source of compensation for bankruptcy trustees in typical "no asset" bankruptcy cases. A "no-asset" case is a consumer chapter 7 bankruptcy case in which there are no assets available to satisfy any portion of the unsecured claims of the creditors, or a case in which all of the individual debtor's property is exempt. While the overwhelming majority (perhaps in excess of 95%) of chapter 7 cases are "no asset," the bankruptcy trustee must still perform a variety of time-consuming duties, such as preparing for and conducting the meeting of creditors (commonly known as the section 341 meeting (11 U.S.C. §341)), verifying information sought by the U.S. Trustee, ensuring that tax returns are filed, and examining the documents filed by the debtor. In the rare "asset" case, the chapter 7 bankruptcy trustee receives a commission on the assets administered.

Presently, bankruptcy trustees are compensated just $60 for each bankruptcy case they handle (except for those cases in which the 2005 Amendments have waived a fee). The proposed legislation seeks to increase the fee to approximately $120 per case. This fee increase would be the first in about 14 years.

During the time from the last fee increase, a bankruptcy trustee's duties and responsibilities have increased substantially. Typically, a bankruptcy trustee is charged with a large number of important duties, among them the administration, investigation, and oversight of a bankruptcy case. Bankruptcy trustees undertake various investigatory and audit functions and prepare reports of their findings. In many districts, the bankruptcy trustee engages in follow-up investigations regarding the new means testing, a requirement added by the 2005 amendments and generally administered by the U.S. Trustee. For example, the bankruptcy trustee may be tasked with assisting the U.S. Trustee by gathering and/or verifying information and or documentation for the U.S. Trustee's implementation of the new means test (including Current Monthly Income (CMI) data, tax returns, and documentation of certain expenses on Form 22A), additional section 341 meeting questioning imposed by the 2005 amendments, domestic support obligations (DSO) noticing, confirming credit counseling, and monitoring misconduct issues concerning attorneys, petition preparers, and debt relief agencies (DRA). Many, but not all of these trustee duties, are found in Bankruptcy Code section 704 (11 U.S.C. §704). These duties are not only important for the orderly administration of a bankruptcy case, but absolutely essential to preserve the integrity of the bankruptcy system.

The bankruptcy trustee also serves as the "face" of the bankruptcy process, meeting with each debtor that files a chapter 7 bankruptcy case. For the vast majority of Americans, this is the "face" that they assign to the federal judicial process. It is essentially that we continue to attract highly competent, honest, and fair-minded individuals to serve as bankruptcy trustees. To be sure, no one becomes a bankruptcy trustee to get rich; theirs is a calling of public service. However, it serves no one to deny them reasonable compensation for the public service they provide.

To paraphrase an old Chinese curse, "We live in interesting times." The next year in bankruptcy should be an "interesting time." All the best and happy 25th Anniversary to the AIRA!



Taxation Cases

Forrest Lewis
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TAX PLANNING FOR LIQUIDATING TRANSFERS

Usually the most critical year for tax planning in the bankruptcy liquidation of a debtor C corporation is the year that all or substantially all assets are transferred to the creditors or to a liquidating trust. There are often three primary problem areas in such transfers:

1. Alternative minimum tax
2. Basis issues for both the debtor and the creditors
3. Reduction of favorable tax attributes for the debtor

The transfer of assets to creditors in satisfaction of their claims is treated as a taxable sale. For garden variety recourse claims such as unsecured claims, the measure of the taxable gain is the fair market value of the assets less their tax basis in the hands of the debtor. [IRS Reg. 1.1001-2] Usually the transferred assets only partly satisfy the claims of the creditors so this article will assume that the total of claims exceed the value of assets transferred.

Alternative minimum tax

Typically C corporations in bankruptcy have substantial net operating loss carryforwards plus they incur considerable administrative expenses in the course of the bankruptcy administration. However, the amount of the taxable gains on liquidating transfers to creditors can exceed the loss on operations in the year of a large distribution. The net operating loss carryovers usually eliminate any regular tax but there is a 90% limitation on the amount of alternative tax net operating loss carryforwards which can be used. [IRC Sec. 56(d)(1)] The 10% difference often results in a relatively small nuisance amount of alternative minimum tax to pay. This often catches both advisers and clients by surprise when they have been sailing along paying no income tax for several years.

Basis issues

The basis of creditors in their claims can become a very complex issue. A cash basis creditor has no tax basis in its claim e.g. a cash basis account receivable. Any distribution such a creditor receives is ordinary taxable income by definition. Concomitantly, the cash basis creditor will never be allowed a bad debt deduction. The rest of this discussion will focus on an accrual basis creditor who will have a tax basis equal to the amount of gross income recognized in the course of the sale or performance of services. The following is a simplified example:

> Box Company sells a palate of packaging materials to Shaky Corporation on credit for $1,000. Box then has a basis of $1,000 in its account receivable. Six months later the invoice is still unpaid and Shaky files a petition in Chapter 11. If Box does not write off its account receivable as uncollectible, it continues to have a basis of $1,000 in its unsecured claim. In the second year of bankruptcy administration, it is determined that Shaky will simply liquidate. Shaky distributes assets valued at $400 to Box. Box then has a $400 "purchase" basis in the assets distributed and takes a $600 ($1,000-$400) bad debt deduction .

Instead of making individual distributions, usually a liquidating trust is established to receive the debtor assets and allow orderly continuation of the claims reconciliation process. In practice, the debtor assets are distributed to the liquidating trust but for tax purposes they are deemed to be distributed to the creditors and then contributed by them to the liquidating trust which is treated as a grantor trust. [see Rev. Proc. 94-45]. In a grantor trust any income or loss passes through to the beneficiaries each year. Let's continue the illustration:

> Shaky actually distributes $4 million in assets to a liquidating trust for benefit of the unsecured creditor class with claims totaling $10 million. Box Company has a $400 (4/10 x $1,000) basis in its beneficiary interest in the liquidating trust upon formation and it takes a $600 ($1,000-$400) bad debt deduction. Each year the Shaky Liquidating Trust realizes operating losses and makes cash distributions. Box Company's combined share of the operating losses and cash distributions during the life of the Liquidating Trust serve to reduce the $400 basis.

The problem with the foregoing scenario is that many times, the creditor writes off its entire basis in the account receivable as soon as it receives notice of the filing of the petition despite the fact that the IRS feels this is premature where there are substantial assets to be distributed [IRS Reg. 1.166-2]. Changing the preceding example, Box would have $400 of taxable income at the time of the formation of the Liquidating Trust if it had already taken a $1,000 bad debt deduction. Presumably, if Box fails to recognize the $400 of income on receipt of the beneficiary interest in the trust, it has no basis in its interest. This lack of basis is a common problem and the adviser should steer clear of assuming the beneficiary has any certain basis and should disclaim any advice on any beneficiary basis related determinations.

Generally the liquidating trust takes a "purchase" basis in the assets transferred from the debtor, assuming no inconsistent valuation treatment. In this context, a significant source of basis issues are preferences and legal causes of action such as lawsuits including officer and director suits, malpractice claims against professionals, etc. These are unrecorded assets of the debtor which will be transferred to the liquidating trust but they have no tax basis in the hands of the debtor. Any value assigned to them will create a taxable gain upon transfer, so valuing them is very tricky. While it is rare that the maximum amount is recovered, some attorneys do not like to value them below the maximum amount being sought out of concern that such lower valuation will be used against the debtor in court or in negotiations. However, this creates a tension as it can have an immediate cost in terms of additional alternative minimum tax as mentioned earlier. On the other hand, if no value is assigned to these intangible assets, it can accelerate tax in the liquidating trust. Example:

> Trouble Corporation, a debtor in Chapter 11, transfers $12 million in preference claims and causes of action to a liquidating trust but no value is assigned either by

the debtor corporation nor the liquidating trust. Thus, those intangible assets have no tax basis in the hands of the Liquidating Trust. Subsequently, the liquidating trust wins a $4 million judgment against the former directors and officers and collects from the D&O insurance policy. The liquidating trust now has $4 million of unforeseen taxable income. Unless the $4 million can immediately be distributed, the managers of the liquidating trust may find themselves criticized for creating taxable income to the beneficiaries with no cash distributed to pay the tax. The entire problem could have been avoided by properly valuing the preferences and causes of action at time of transfer.

Planning for basis: The debtor and the liquidating trust need to strike a balance in valuing assets distributed, being sure to identify and appropriately value intangible assets such as lawsuits and preferences. Putting an unrealistically high value on the assets may incur needless alternative minimum tax in the debtor corporation. Undervaluing the assets may result in unforeseen taxable gains in the early years of the liquidating trust and uncomfortable situations where the beneficiaries are subject to tax perhaps without cash distributions to pay the tax.

Reduction of favorable tax attributes

As highlighted in an article in this column in the December 2008-January 2009 issue, occasionally you encounter situations in which some distributions are made in one year of bankruptcy administration and some in later years. If distributions made in one year result in discharge of some debts, certain favorable tax attribute carryforwards will be reduced in an amount equal to the debt discharged and excluded from taxable income under IRC Sec. 108(a)(1). If all distributions and debt discharges are made in the same tax year of the debtor, there is no problem as any favorable tax attribute reduction takes place only after the determination of the tax for that year [IRC 108(b)(4)]. However, sometimes sales of assets or distributions of assets get spread over several years which can incur additional taxes. Here is an oversimplified example:

In Year 1 of a Ch. 11 proceeding, a secured class of lenders with recourse claims totaling $50 million receive $30 million in assets (undersecured). For simplicity's sake, we will assume the $20 million deficiency is discharged. Under Sec. 108(a)(1)(A) the discharge income is excluded from the debtor's taxable income. The debtor had $15 million in net operating losses at the beginning of Year 1, but those are now eliminated as of the end of Year 1 by the excluded discharge of debt income. In January of Year 2, the remaining assets of the debtor are transferred to a liquidating trust for the unsecured creditor class which causes a $5 million gain. The debtor will pay tax on the $5 million gain. Had the $5 million gain been incurred in Year 1, no tax would be due (or at worst a small alternative minimum tax).

Conclusion

In a C corporation in bankruptcy liquidation, the timing of sales, distributions of property and transfers to liquidating trusts should be carefully planned. It is usually best if such transfers can take place in the same tax year as the date on which debts are discharged (usually plan confirmation date or effective date, if different). All assets, including intangibles, which have value should be recognized and appropriately valued before being transferred to any liquidating trust. The value should be realistic in view of the amount of cash they will ultimately generate. Because so many creditors have partly or completely written off their claims long before formation of the liquidating trust, the adviser should beware of making any statements to beneficiaries as to the amount of their basis or any calculations for the beneficiary which involve basis. A small amount of alternative minimum tax is often incurred in the year in which the debtor transfers assets to a liquidating trust. While little can usually be done to avoid this tax, it is important to inform the debtor and trustee in advance that it will occur. ■

MORE ON COD DEFERRAL

As discussed in the last issue, The American Recovery and Reinvestment Tax Act of 2009 added Internal Revenue Code subsection 108(i) which provides for a deferral of cancellation of debt ((COD) income resulting from reacquisition of certain of the taxpayer's own debt instruments. The new provision is turning out to be rather broad and user-friendly in its scope. Besides reacquisition of publicly traded bonds, it appears to apply to write offs and compromises of garden variety privately issued notes in a business setting. Under the new law and at the election of the taxpayer, income from the discharge of indebtedness in connection with the "reacquisition" after December 31, 2008, and before January 1, 2011, of an applicable debt instrument is includible in gross income ratably over a five-tax-year period.

Two issues have emerged and received unofficial comment from the IRS so far.

1).Foreclosures and conveyances of collateral in partial satisfaction of debt

There is concern whether COD income resulting to a borrower from a foreclosure or other reduction in a debt which is partially satisfied by delivering collateral property qualifies. The concern arises from the fact that in the original Senate version of the provision only applied to "repurchases for cash." The Conference Committee broadened the provision to the following:

> "A "reacquisition" is any "acquisition" of an applicable debt instrument by (1) the debtor that issued (or is otherwise the obligor under) such debt instrument or (2) any person related to the debtor within the meaning of section 108(c)(4). For purposes of the provision, an "acquisition" includes, without limitation, (I) an acquisition of a debt instrument for cash, (2) the exchange of a debt instrument for another debt instrument (including an exchange resulting from a modification of a debt instrument), (3) the exchange of corporate stock or a partnership interest for a debt instrument, (4) the contribution of a debt instrument to the capital of the issuer, and (5) the complete forgiveness of a debt instrument by a holder of such instrument."

While the Committee Report passage cited does not specifically include exchanges of debt for tangible property, BNA Daily Tax Reports quoted a highly placed IRS official as saying that "I would think that debt for property would be a transaction that would be covered by 108(i)…If that needs to be clarified, then that's something we'll do." [Until the IRS makes a formal statement on this, practitioners need to proceed with caution—FL]

2).Application to partnerships

Despite the fact most COD tax calculations are made the partner level, this provision is administered in a mixed fashion between the partner and the partnership level. The statute is quite clear that the election for partnerships, and other passthroughs, is made at the partnership level. This is what the Conference Committee Report says about how the rules will work:

> "In the case of a partnership, any income deferred under the provision is allocated to the partners in the partnership immediately before the discharge of indebtedness in the manner such amounts would have been included in the distributive shares of such partners under section 704 if such income were recognized at the time of the discharge. Any decrease in a partner's share of liabilities as a result of such discharge is not taken into account for purposes of section 752 at the time of the discharge to the extent the deemed distribution under section 752 would cause the partner to recognize gain under section 731. Thus, the deemed distribution under section 752 is deferred with respect to a partner to the extent it exceeds such partner's basis. Amounts so deferred are taken into account at the same time, and to the extent remaining in the same amount, as income deferred under the provision is recognized by the partner."

Thus the individual tracking of the deferred amount and recognition of the tax takes place at the partner level. Also, a disposition of the partnership interest by the partner causes acceleration of the partner's remaining deferred income. In essence, the partner is under a dual threat of acceleration, both from the possibility of liquidation of the partnership as a whole and a disposition by the partner of his interest. [Query: does an otherwise fairly harmless "termination" of a partnership by a change in more than 50% of the ownership interest accelerate the deferred income for even the continuing partners?]

While some commenters have asked that a partner be allowed to opt out, IRS reportedly has initially reacted negatively to that suggestion because of concerns about problems administering such a rule.

Another issue which must be watched is that the COD income arises from borrowing in connection with a business activity within the partnership. The business connection is required to qualify for the five year deferral.

It will be interesting to watch the details of this new provision evolve. ■

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

Bankruptcy Cases

Baxter Dunaway

Eleventh Circuit

Is lease termination payment avoidable as preferential transfer under § 547(b)(2)?

Lease termination payment is avoidable as preferential transfer under § 547(b)(2). *Midwest Holding #7, LLC v. Anderson (In re Tanner Family, LLC)*, No. 08-12462, 2009 WL 238262 (11th Cir. Feb. 3, 2009). Debtor filed bankruptcy within 90 days of payment for release from commercial lease. Trustee sought to avoid payment, but landlord argued the fee was not for an antecedent debt, rather it extinguished an unmatured claim for future rent. Bankruptcy Code has broadest possible definition of debt, including unliquidated and unmatured claims. The court rejected the lessor's argument that the debt created by a real estate lease is not incurred until it is legally collectible and its further argument that rent was not legally collectible under applicable state law until the first day of the month when rent became due. The court accepted the trustee's argument that debtor's obligation to pay rent for the entire lease term was incurred on the date that the parties entered into the lease agreement. This debt was incurred at signing of lease, making it antecedent to lease termination payment.

Research References: Norton Bankr. L. & Prac. 3d § 66:10

Third Circuit

Can a creditor's claim be subordinated to an equity interest?

Bankruptcy Code § 510(c) does not permit the subordination of debt to equity. In re Winstar Communications, Inc., 554 F.3d 382, 414; 51 Bankr.Ct.Dec. 45; Bankr. L. Rep. P 81,408(3rd Cir.(Del.) Feb 03, 2009) (NO. 07-2569). Section 510(c) provides that a court may equitably subordinate "all or part of an allowed claim to all *or* part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest."(emphasis added). The Bankruptcy Code distinguishes between a "proof of claim," which may be filed by a "creditor," and a "proof of interest," which may be filed by an "equity security holder." 11 U.S.C. § 501(a). *See generally* *In re Insilco Techs., Inc.*, 480 F.3d 212, 217-18 (3d Cir.2007) (noting that, under the Bankruptcy Code, "the distinction between creditors (who hold 'claims' against the estate) and equity investors (who hold 'interests' in the estate) is important, for holders of claims receive much more favorable treatment than holders of interests. Equity investment brings not a right to payment, but a share of ownership in the debtor's assets-a share that is subject to all of the debtor's payment obligations."). Thus, the court read § 510(c) to clearly incorporate the distinction between claims and interests such that creditors' claims may not be equitably subordinated to equity interests. *See Collier on Bankruptcy* at § 510.05 ("Under subsection (c)(1), claims may be subordinated to claims, and interests may be subordinated to interests, but claims may not be subordinated to interests.").

Ninth Circuit

Upon dismissal of involuntary petition, may bankruptcy court require certain petitioning creditors to pay debtor's attorney's fees and costs pursuant to § 303(i)(1) without imposing liability on all petitioning creditors?

Upon dismissal of involuntary petition, bankruptcy court may require certain petitioning creditors to pay debtor's attorney's fees and costs pursuant to § 303(i)(1) without imposing liability on all petitioning creditors. *Sofris v. Maple-Whitworth, Inc. (In re Maple-Whitworth, Inc.)*, No. 07-56537, 2009 WL 310902 (9th Cir. Feb. 10, 2009). The court may consider factors such as relative culpability among petitioners, motives and objectives of petitioners and reasonableness of conduct of debtors and creditors. See generally, Award of Attorney's Fees Under § 303(i)(1)(B) of Bankruptcy Code (11 U.S.C.A. § 303(i)(1)(B)) on Dismissal of Involuntary Petition in Bankruptcy, 179 A.L.R. Fed. 549 (2002).

Sixth Circuit

In deciding whether to revoke a technical abandonment of property under § 554(c), what guidelines should courts apply?

As an issue of first impression, the Sixth Circuit held that in deciding whether to revoke a technical abandonment of property under § 554(c), courts should apply the guidelines of Federal Rule of Civil Procedure 60(b). *LPP Mortgage, Ltd. v. Brinley*, 547 F.3d 643 (6th Cir. 2008). Debtors' cases closed while appeals concerning liens on their respective properties were still pending. Upon resolution of the appeals concerning the correct lien amounts, the cases were reopened to preserve for the benefit of the estate the unencumbered equity in the properties. Debtors contended, however, that under § 554(c)[1] the trustee abandoned the property to the debtors at the closing of the cases. The court held that Rule 60(b) strikes the appropriate balance between promoting finality and allowing courts to grant relief in limited circumstances. Applying Rule 60(b), the trustee was entitled to relief from the technical abandonment. 2009 NO. 2 NRTN-BLA 3.

Research References: Norton Bankr. L. & Prac. 3d §§ 63:1 to 63:7

Seventh Circuit

After Chapter 12 debtors moved, post-confirmation, to dismiss their case, did the bankruptcy court abuse its discretion in determining that "cause" existed under 11 U.S.C.A. § 349(b) for the confirmed plan to remain binding on the parties?

After Chapter 12 debtors moved, post-confirmation, to dismiss their case, the bankruptcy court did not abuse its discretion in determining that "cause" existed under 11 U.S.C.A. § 349(b) for the confirmed plan, which, inter alia, required the debtors to release purported "lender liability" claims against a bank, to remain binding on the parties.

1 Often referred to as technical abandonment, 11 U.S.C. § 554(c) provides that "any property scheduled under section 521(1) of this title not otherwise administered at the time of the closing of a case is abandoned to the debtor."

Wiese v. Community Bank of Cent. Wis., 552 F.3d 584, 51 Bankr.Ct.Dec. 12, Bankr. L. Rep. P 81,390 (7th Cir.(Wis.) Jan 08, 2009) (NO. 07-3753). Chapter 12 bankruptcy was created to give family farmers facing bankruptcy a chance to reorganize their debts and keep their land. A plan cannot be confirmed without the consent of a holder of a secured claim where the holder does not accept the plan or the debtor does not surrender the collateral, unless (1) the plan provides that the holder retain the lien securing the claim; and (2) the value of property to be distributed to the debtor or trustee under the plan with respect to that claim is not less than the allowed amount of the claim. Once the plan is confirmed, it is binding on the debtor and the creditors. 11 U.S.C. § 1227(a). However, a debtor can request at any time that the court dismiss the case (unless it has been converted to a Chapter 7 or Chapter 11 bankruptcy), and the court must dismiss it. *Id.*§ 1208(b). The debtor cannot waive his right to dismiss the case. *Id.* A dismissal reinstates avoided transfers or voided liens made under certain provisions of the bankruptcy code, vacates certain types of orders made under the code, and "revests the property of the estate in the entity in which such property was vested immediately before the commencement of the case," unless the bankruptcy court orders otherwise for "cause." *Id.*§ 349(b). In holding that there was cause to under § 349 to keep the plan binding on the parties, the court reasoned:

> We now look to the record for evidence of the concessions the bankruptcy court considered when it made the "cause" determination. We do not have to look far. The Wieses needed the Bank's consent to confirm the plan, and the Bank was apparently interested in obtaining a release of the lender liability claims. The Wieses induced the Bank to consent to the plan by including the release in their final amended plan. They got what they bargained for-a confirmed plan. In the plan, the Bank agreed (among other things) to give up a lien it had on some funds held in escrow. After confirmation of the plan, the money in escrow was released to the Wieses, and the Bank lost the ability to collect it. The Bank's agreement to give up the lien was made "in reliance on the bankruptcy case," and when the Wieses decided to dismiss the case, it was not inappropriate for the bankruptcy court to consider the harm that dismissal caused to the Bank. The bankruptcy court may have also considered hints of bad faith on the Wieses' part- the record contains references to investigations of "missing" cows or cows sold under the Wieses' children's names, unauthorized credit card use after the bankruptcy petition was filed (to the tune of $35,000), and failure to begin the process of liquidating assets after default in accordance with the plan (not to mention the Wieses' desire to vacate the plan six days after its confirmation for failure to obtain a loan that they knew all along they might not be able to obtain). *Id.* 590.

Research References: Dunaway, The Law of Distressed Real Estate, Ch 36 Bankruptcy– Farms and Ranches; Bankruptcy Service, L. Ed. §§ 17:195, 17:238; Norton Bankr. L. & Prac. 3d §§ 132:9, 148:6; Norton Bankr. L. & Prac. 3d 11 U.S.C. § 349 ; Bankruptcy Law Manual 5d § 11:8.

Bankruptcy Court

Is a flat rate prepayment premium reasonable, and, therefore, allowable under § 506(b)?2

In *In re Atrium View, LLC*, 51 Bankr. Ct.Dec. 2, 2008 WL 5378293 (Bankr. M.D. Pa., Dec. 24, 2008), there was an auction sale of the commercial property in bankruptcy, and three mortgage liens against the property. There was enough money from the proceeds to pay off the first mortgagee (minus the prepayment premium) and partially pay the second mortgage. The court disallowed the first lender's prepayment premium and the first mortgagee objected, arguing it should receive its contracted-for prepayment premium. The first lender's note contained a provision requiring the debtor to pay a "prepayment premium" if it prepaid all or part of the debt, voluntary or otherwise, within three years of the date of the note. The debtor filed its bankruptcy petition a little more than a year after the first mortgage note was executed by the debtor.

The court rejected the first lender's objection, and stated, at *3:

In the instant case, [the lender] provided no evidence that the prepayment premium approximates predicted actual losses. A flat fee that is the same regardless of how many months interest is lost and that is unrelated to the market interest rate clearly is not based on a forecast of actual damages". The court further stated that "[The lender's] only justification in support of the [prepayment] provision is that '[i]n the current residential subprime mortgage industry, a typical prepayment premium is six months' interest." While a six-month prepayment penalty may be inserted routinely in mortgage notes, that does not mean this provision passes muster in the bankruptcy context. [The lender] has not shown that the prepayment premium is reasonable, and, therefore, it is disallowed under § 506(b). <http://web2.westlaw.com/find/default.wl?tf=-1&rs=WLW8.11&referencepositiontype=T&ifm=NotSet&fn=_top&sv=Split&referenceposition=SP%3ba83b000018c76&docname=11USCAS506&tc=-1&ordoc=2017747057&findtype=L&db=1000546&vr=2.0&rp=%2ffind%2fdefault.wl&mt=Westlaw> .

The bankruptcy court therefore disallowed the amount of the premium claimed by the first lender and ordered distribution of that amount ($15,815), which was held in escrow, to the second lender because it had not been paid in full and such distribution would still not be enough to pay the second lender's claim in full; therefore there were no funds available for the third lender.

Comment 1: This case illustrates the affinity of bankruptcy courts to find a reason to "spread the proceeds around" to secured creditors (and unsecured creditors when possible) when there are not enough funds from a sale to pay them in full. The court stated that prepayment premium clauses

2 Analysis by Jack Murray, Vice President and Special Counsel, First American Title Insurance Co., Suite 2700, 30 North LaSalle, Chicago, Ill. 60602.

are enforceable in Pennsylvania with respect to commercial loans, stating that "if the parties manifest an intent in the instrument to provide for a prepayment fee and the fee serves as measure of liquidated damages, payment of the fee will be enforced (citation omitted)." This again underscores the fact that many bankruptcy courts (and some state courts) have a basic misunderstanding of prepayment provisions, which should not be subjected to a liquidated damages analysis in connection with a commercial loan. This is certainly not a majority position. The bankruptcy court then looked to Sec. 506(b) of the Bankruptcy Code and, relying selectively on the distinct minority of courts that support its position, stated that "A prepayment charge formula must effectively estimate actual damages, otherwise, the charges may operate as either a penalty on the debtor or a windfall to a lender, at the expense of other creditors of the bankruptcy estate."

Comment 2: This case demonstrates the danger to lenders in not inserting a standard yield-maintenance prepayment provision in the loan documents, and instead using a non-standard "flat rate" or "sliding percentage scale" provision. These types of clauses (which are still used by some lenders, especially in connection with some subprime and securitized loans) are subject to rejection by both bankruptcy and state courts, even if (as argued by the lender), "In the current residential subprime mortgage industry, a typical prepayment premium is six months' interest." Bankruptcy courts (and state courts) generally see much more justification for enforcing a standard (and well-drafted) yield-maintenance prepayment provision in mortgage loan documents, because they have become standard in the industry and appear to truly attempt to quantify the lender's estimated damages.

Bankruptcy Court

Will ambiguity in a yield-maintenance prepayment provision in the loan agreement be construed against the lender?3

3 Analysis by Jack Murray, Vice President and Special Counsel, First American Title Insurance Co., Suite 2700, 30 North LaSalle, Chicago, Ill. 60602.

In *Sundance Apartments I, Inc. v. General Electric Capital Corp.*, 581 F.Supp. 2d 1215 (U.S.D.C. S.D. Florida 2008), the borrower, Sundance Apartments I, LLC ("Sundance"), brought an action against the lender (the trustee of a commercial mortgage-backed security trust created by the lender) and the servicer, claiming that the yield-maintenance prepayment provision in the loan agreement was "deceptive," forcing the borrower Sundance to make a prepayment (under protest) in excess of the actual premium due. The court agreed with Sundance's interpretation of the provision, upholding the borrower's claims of breach of contract and violation of the Florida Deceptive and Unfair Trade Practices Act as valid claims, and denied the lender's and servicer's motions to dismiss. The yield-maintenance provision in the Loan Agreement entered into between the parties read as follows:

> As used herein, "Yield Maintenance Amount" means the sum of the present value on the date of prepayment of each Monthly Interest Shortfall (as hereinafter defined) for the remaining term of the Loan discounted at the Discount Rate.
>
> The Monthly Interest Shortfall is calculated for each monthly payment date and is the product of (A) the prepaid principal balance of the Loan divided by 12, and (B) the positive result, if any, from (1) the yield derived from compounding semi-annually the Loan's Contract Rate minus (2) the Replacement Treasury Rate (as hereinafter defined).

The court summarized the parties' arguments as follows, based on the language in the above prepayment provision:

Sundance alleges that the term "prepaid principal balance" found in the [yield maintenance] Provision must be read to mean "the prepaid balance of the loan for each payment remaining in the term as amortized" in light of its plain meaning and industry custom. Defendants, however, rejected that interpretation and instead read the term to mean "a principal balance fixed at the time of prepayment," which allegedly generates a windfall (the "Windfall Interpretation") and permitted Defendants to recover a yield greater than they would have recovered if Sundance had made its regular payments through the maturity of the loan. Id. at 1218.

The court ruled that the provision was deceptive and misleading because it "was intended to allow [the lender], or its successor, to charge Sundance a repayment amount that allegedly exceeds the plain meaning and common understanding of the term 'yield maintenance.'" Id. at 1221. Sundance alleged that it had suffered "actual damages" when it paid the prepayment amount demanded by the lender under protest, and argued that its actual damages should be "calculated as the difference between the alleged correct yield maintenance prepayment amount and the Windfall Interpretation as well as costs, attorney's fees, and other relief." Id. at 1219.

Comment 1: This case clearly illustrates the importance of clarity and completeness when drafting yield-maintenance provisions in mortgage-loan documents, as any ambiguity will undoubtedly be construed by a court in the borrower's favor when the lender has drafted the loan documents. Yield maintenance prepayment premiums are generally enforced by state courts (and even most bankruptcy courts) because they are considered commercially reasonable and have become standard in the industry over the past years (and many courts have given "guidelines" as to how these clauses should read in order to be enforceable). Yield-maintenance prepayment provisions have been inserted in commercial mortgage loan documents since the early 1980's, and are familiar to virtually all commercial borrowers.

Comment 2: A prepayment premium clause will only be enforced to the extent permitted by the express contractual language in the loan document itself, and this is the area where most clever borrowers are still able to spot any "opening" to challenge the clause. There is simply no excuse for ambiguity or sloppiness by lenders in drafting these clauses, as the case law has become quite clear as to the language required to ensure enforcement, even where the court (mistakenly) applies a liquidated damages analysis.

Court of Appeals of Kansas

Is MERS as a recorded "mortgagee", entitled to be served or joined as a party to the foreclosure of a senior mortgage because it is a " nominee"?

The Kansas Court of Appeals held that although MERS is recorded as a mortgagee, it is not entitled to be served or joined as a party to the foreclosure of a senior mortgage because it is a "mere nominee," and not a true obligee under the debt or holder of rights under the mortgage. Landmark Nat. Bank v. Kesler, 40 Kan.App.2d 325, 192 P.3d 177 (Kan.App. Sep 12, 2008) (NO. 98,489).

Kesler had a first mortgage on Kansas property. There was a second mortgage securing a debt loaned by Millennia, but Millennia participated in the MERS process and anticipated transferring its loan on the secondary market, so it arranged for the original recording of the loan to be in the name of MERS, as nominee for Millennia or its assigns. Subsequently, the mortgage was assigned on to Sovereign Bank, and the assignment was duly recorded on MERS database. No assignment was recorded, since MERS, by virtue of agreement of Millennia and Sovereign, now stood as nominee of Sovereign.[4]

Kesler defaulted on the first mortgage and Landmark, the first mortgagee, instituted judicial foreclosure proceedings. Apparently it sought advice from a title insurer, which advised it to serve only Millennia and Kesler, even though MERS was of record, and even though the identity of the current owner of the mortgage could have been found by checking with MERS.[5] Note that Millennia was not of record as the holder of the mortgage, but it is assumed that the title company somehow was informed that Millennia was the original mortgagee of the MERS recorded mortgage.

Both Kesler and Millennia failed to appear at the hearing on the foreclosure of the first , and the court entered a default judgment of foreclosure, with the sale to be conducted at a later date by the sheriff and thereafter to be confirmed by the court.[6] Before the sheriff's sale, Sovereign found out what was happening and appeared in court asking to intervene and to set aside the judgment. Sovereign appeared after the sheriff's auction, but before the required judicial confirmation of the sale. The trial court ruled, however, that Sovereign was far beyond the ten day period following the judgment that Kansas permits for intervenors.

Another party, Mortgage Electronic Registration Systems, Inc. ("MERS"), also filed a motion to set aside the judgment and asserted that it held legal title to the mortgage, originally on behalf of Millennia and later on behalf of Sovereign. Both Sovereign and MERS claimed that MERS was a necessary party to the foreclosure lawsuit and that the judgment must be set aside because MERS wasn't included on the foreclosure suit as a defendant.

The district court refused to set aside its judgment. The court found that MERS was not a necessary party and that Sovereign had not sufficiently demonstrated its interest in the property to justify setting aside the foreclosure. The Court of Appeals held: "In this case, we are only required to address whether the failure to name and serve MERS as a defendant in a foreclosure action in which the lender of record has been served is such a fatal defect that the foreclosure judgment must be set aside. We hold that it is not." 40 Kan. App. 325, 331-2.

In addition to the claim that MERS was a necessary party under K.S.A. 60-219, MERS and Sovereign also argued that the failure to include MERS violated its due process rights. On this, the Court held: "But MERS had no direct property interests at stake; even its right to act on behalf of its principal was not at issue in Landmark's suit. Without a property interest at stake, there can be no due process violation." 40 Kan. App. 325, 331.

Comment: This case will undoubtably be appealed. The case has a narrow holding, but if the holding is affirmed the implications could be far reaching. Countless numbers of transfers of mortgages (notes secured by mortgages) are made in the traditional secondary market and in the process of asset securitization. A mortgage may be transferred more than once during its term. Change in servicing rights of mortgages are commonly made. More than $400 billion in servicing contracts trade annually. Mortgages are transferred by outright sale, and transfers of security interests are also common. A major problem is keeping track of the legal ownership of the mortgage. Particularly burdensome is recording in the state recording systems of the assignment of the mortgage, when large groups of mortgages are transferred. To partially address this problem, the Mortgage Electronic Registration System, generally referred to as MERS, was developed. The MERS concept calls for the establishment of a central, electronic registry for tracking mortgage rights. By using an electronic mailroom, mortgage sellers, warehouse lenders, mortgage investors, document custodians, mortgage servicers, and other participants in the lending industry are able to obtain, transfer, and identify interests in mortgages essentially on a real-time basis. Parties are able to access the central registry (on a need to know basis), and the registry is to communicate with them, even though each may be using proprietary business systems for internal operations. See Dunaway, Law of Distressed Real Estate, § 24:20. Transfer of mortgage: Recording statutes—Mortgage Electronic Recording System (MERS). According to the MERS's Commercial Legal Primer, residential MERS members have completed over 20,000 foreclosures in 50 jurisdictions (both judicial and non-judicial jurisdictions). See MERS® COMMERCIAL: LEGAL PRIMER, 548 PLI/Real 185, 359 (January-March, 2008).

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4 Patrick A. Randolph, Jr., Quarterly Report on Current Developments in Real Estate Law, 563 PLI/Real 665 (July 1 to September 20, 2008) (some of the information was obtained from an attorney on the case).

5 In a foreclosure suit, it is normal practice to name as defendants all parties who may claim a lien against the property.

6 40 Kan.App.2d 325, 326.

from a bankruptcy court to commence certain claims and causes of action on behalf of the estate, start and commence such litigation but cannot bring such litigation to conclusion by reason of a non-consensual settlement proposed by the debtor, is an absurd result, apparently inconsistent with the rulings of *STN*, *Commodore*, *Housecraft*, and *Cybergenics*.

Second, such a result could have the effect of shielding the debtor's pre-petition lenders from any liability, even if (a) an action is commenced by a creditors' committee against the pre-petition lenders, and (b) the debtor expressly waived its right to commence any claims or causes of action against its pre-petition lenders pursuant to the debtor-in-possession financing orders ("DIP order") and/or cash collateral orders that were previously entered in the case. It is common practice in a Chapter 11 proceeding for a debtor, in consideration for its receipt of post-petition financing and/or its ability to use the cash collateral of its pre-petition lenders, to expressly waive its right to commence any claim or cause of action against its pre-petition lenders, while carving out from such a waiver the right for a creditors' committee or trustee, if one is appointed, to do so. If a DIP order or cash collateral order expressly provides that the debtor waives any and all rights to commence any claim or cause of action against its pre-petition lenders, it is illogical, inequitable, and unfair for the debtor to thereafter attempt to settle any action that is subsequently commenced against the lenders by a creditors' committee without the committee's consent.[3]

This article will examine Rule 9019 and its interplay with Section 1123(b)(3)(A) and suggests to creditors' committees who wish to commence actions as estate representatives to do so without the fear of a debtor being able to settle such actions without the committee's consent.

Overview of Bankruptcy Rule 9019 and Related Practice

Bankruptcy courts derive their authority to approve compromises from Rule 9019(a) of the Federal Rules of Bankruptcy Procedure, which states:

> (a) Compromise. On motion by the trustee and after a hearing on notice to creditors, the debtor and indenture trustees as provided in Rule 2002(a) and to such other persons as the court may designate, the court may approve a compromise and settlement.

Fed. R. Bankr. P. 9019(a).

The proponent of a settlement or compromise has the burden of persuading the court that the proposed settlement is reasonable and appropriate and is in the best interests of the debtor and its estate and creditors. *See In re Ionosphere Clubs, Inc.*, 156 B.R. 414, 426 (S.D.N.Y. 1933), *aff'd*, 17 F.3d 600 (2d Cir. 1994); *In re Bell and Beckwith*, 93 B.R. 569, 574 (Bankr. N.D. Ohio 1988).

The decision whether to approve or disapprove a settlement is within the sound discretion of the bankruptcy court. *In re Drexel Burnham Lambert Group, Inc.*, 134 B.R. 499, 505 (Bankr. S.D.N.Y. 1991); *In re Hydronic Enterprise, Inc.*, 58 B.R. 363, 365 (Bankr. D.R.I. 1986); *In re Bell & Beckwith*, 93 B.R. at 574.

A court should consider the following five factors in striking the balance between the value of the compromise and the value of the claim: (1) the probability of success in the litigation; (2) the likely difficulties in collection; (3) the complexity of the litigation; (4) the expense, inconvenience, and delay necessarily attending it; and (5) the paramount interest of the creditors. *See In re Martin*, 91 F.3d 389, 393 (3d Cir. 1996); *In re Neshaminy Office Bldg. Assocs.*, 62 B.R. 798, 803 (E.D. Pa. 1986).

In assessing whether a proposed settlement is in the best interest of the estate, a bankruptcy court "must develop an understanding of the value of the rights being relinquished by [the estate] and the value of what [the estate] receives in return." *In re Neshaminy Office Bldg. Assocs.*, 62 B.R. at 804. The party proposing the settlement or compromise must show that the settlement or compromise is reasonable and that:

> (1) the settlement was not collusive;
>
> (2) the proponents have counsel experienced in similar cases;
>
> (3) there has been sufficient discovery of the underlying claims of parties to enable counsel to act intelligently; and
>
> (4) the number of objectors or their relative interests are small.

In re Matco Electronics Group, Inc., 287 B.R. 68, 76 (Bankr. N.D.N.Y. 2002) (*citing In re Del Grosso*, 106 B.R. 165, 168 (Bankr. N.D. Ill. 1989)). The bankruptcy court should also consider the paramount interest of creditors and give proper deference to their reasonable views. *In re Spielfogel*, 211 B.R. 133, 144 (Bankr. E.D.N.Y. 1997). A bankruptcy court "is not finally 'to decide the numerous questions of law and fact raised by [objectors] but rather to canvass the issues and see whether the settlement fall[s] below the lowest point in the range of reasonableness.'" *In re Lion Capital Group*, 49 B.R. 163, 175 (Bankr. S.D.N.Y. 1985) (*quoting Anaconda-Ericsson, Inc. v. Hessen* (*In re Teltronics Servs.*), 762 F.2d 185, 189 (2d Cir. 1985)); *accord*, *Hydronic Enterprise, Inc.*, 58 B.R. at 366. The court, however, is required to do some level of scrutiny. "The information presented to the court, in connection with the proposed settlement, must be sufficient to enable it to make an independent inquiry into these considerations." *In the Matter of Egolf*, 102 B.R. 706, 710 (Bankr. N.D. Ind. 1989) (citations omitted).

In considering a proposed compromise, the bankruptcy court is charged with an affirmative obligation to apprise itself of the underlying facts and to make an independent judgment as to whether the compromise is fair and equitable. *In re American Reserve Corp.*, 841 F.2d

3 These very issues came up in the context of a highly contested confirmation hearing in the Delaware Chapter 11 proceedings of *In re Exide Technologies,* et al., Case No. 02–11125 (KJC), wherein the Debtors' Chapter 11 plan attempted to settle an adversary proceeding commenced by the creditors' committee without the committee's consent. Although confirmation of the plan was denied on numerous grounds, which included the fact that the debtor's proposed settlement could not be approved under the Rule 9019 standards, the Bankruptcy Court simply stated that the plain language of Section 1123(b)(3)(A) of the Bankruptcy Code authorized the debtor to propose a settlement of the committee's action in its plan.

159, 162–63 (7th Cir. 1987); *but see In re Telesphere Communications, Inc.*, 179 B.R. 544, 551 (Bankr. N.D. Ill. 1994) (noting that the Bankruptcy Code's inclusion of an Office of the United States Trustee was intended to remove bankruptcy judges from administrative tasks). Although a bankruptcy court may consider the opinion of the proponent of the settlement in deciding whether to approve the proposed settlement, the court must make an independent determination and cannot simply accept the proponent's word that the settlement is reasonable or "rubber-stamp" the proponent's proposal. *Id.* at 162; *Nellis v. Shugrue*, 165 B.R. 115, 122 (S.D.N.Y. 1994); *In re Ionosphere Clubs, Inc.*, 156 B.R. at 426. Thus, the terms of any settlement require "some more reasonable basis than expediency and the desire to terminate complex and troublesome litigation." *In the Matter of Egolf*, 102 B.R. at 710 (citations omitted). The need for these safeguards are clear—any settlement between a debtor and one of its creditors "necessarily affects the rights of other creditors by reducing the assets of the estate available" to satisfy the claims of other creditors. *See Reynolds v. Commissioner of Internal Revenue*, 861 F.2d 469, 473 (6th Cir. 1988).

Bankruptcy Rule 9019 and Section 1123(b)(3)(A) of the Bankruptcy Code

As set forth in Section 1123, a plan may include provisions for the settlement of claims against the estate. Specifically, Section 1123(b)(3)(A) provides that a plan may provide for "the settlement or adjustment of any claim or interest belonging to the debtor or to the estate." 11 U.S.C. § 1123(b)(3)(A). Although Section 1123(b)(3)(A) provides that a plan "may" provide for a compromise of litigation, it does not create any substantive rights nor does it provide the standards by which a bankruptcy court should review such settlement or compromise. Thus, a bankruptcy court typically makes these determinations in the context of a Rule 9019 motion. Even if a debtor has elected not to file such a motion, seeking instead to include the settlement in a plan of reorganization, the standards that guide the bankruptcy court are nevertheless the same, irrespective of the context in which the settlement is proposed. *See In re Dow Corning Corp.*, 192 B.R. 415, 421 (Bankr. E.D. Mich. 1996) (analysis of bankruptcy court does not vary based on whether compromise is effected separately or in body of plan). "Compromises may be effected separately during reorganization proceedings or in the body of the reorganization plan itself." *In re Texaco Inc.*, 84 B.R. 893, 901 (Bankr. S.D.N.Y. 1988); *accord In re Dow Corning Corp.,* 192 B.R. at 241; *In re AWECO, Inc.*, 725 F.2d 293, 297 (5th Cir. 1984), *cert. denied*, 469 U.S. 880, 105 S. Ct. 244, 83 L.Ed.2d 182 (1984). The standards for approval of a settlement in the context of a Chapter 11 plan require a court to inquire into the reasonableness of proposed settlement, whether the settlement falls below the lowest point on a range of reasonableness and whether the terms of the proposed settlement are fair and equitable. *In re Drexel Burnham Lambert Group, Inc.*, 138 B.R. 723, 758 (Bankr. S.D.N.Y. 1992); *In re Frontier Airlines*, 117 B.R. 588, 592, fn.2 (D. Colo. 1990). In approving a settlement or compromise as part of a plan of reorganization, the bankruptcy court must act independently, on its own initiative, for benefit of all creditors, and such obligation prevails even when creditors are silent. *In re AWECO, Inc.*, 725 F.2d at 299.

Thus, as one can see, while a bankruptcy court has discretion to approve a settlement as part of a reorganization plan, there are limits to that discretion and the court should not approve the compromise or settlement unless it is fair and equitable. *See In re Allegheny Int'l, Inc.*, 118 B.R. 282, 309–311 (Bankr. W.D. Pa. 1990). "A compromise or settlement proposed in connection with a plan of reorganization must be fair and equitable." *In re Jartran, Inc.*, 44 B.R. 331, 381 (Bankr. N.D. Ill. 1984); *see also, In re AWECO, Inc.*, 725 F.2d at 298; *In re Investors Funding Corp.*, 8 B.R. 739, 743 (S.D.N.Y. 1980).

Discussion

Although it is unclear whether procedurally under Section 1123(b)(3)(A) of the Bankruptcy Code, a debtor can settle an action commenced by a creditors' committee without the committee's consent, even if the debtor waived the right to commence that very action under a cash collateral or debtor-in-possession financing order entered in the case, the committee is not without a remedy.

File an Objection to the Proposed Settlement

First and foremost, the committee should file an ardent objection to the settlement and frame the issues under the Rule 9019 standards in support of its request that the bankruptcy court deny the proposed settlement. As the court did in *In re Matco Electronics Group, Inc., supra*, in order for the committee to properly convey to the bankruptcy court how the debtor fails to show that its proposed settlement of the committee's action is reasonable, is in the best interests of the debtor's estate, and otherwise satisfies the "lowest point of reasonableness" standards under Rule 9019, the committee should outline the numerous "red flags" contained in the debtor's proposed settlement. These "red flags" may include: (1) the lack of any arms-length bargaining and negotiating by the debtor; (2) the existence of self-dealing between the debtor and the non-debtor settling party; (3) the fact that the committee had no part in negotiating the proposed settlement; (4) the lack of fair (or any) consideration flowing to the estate in exchange for the claims to be settled and any third-party releases; (5) the lack of any showing that the debtor complied with its fiduciary duties and obligations by having a disinterested board of directors or other representative of its estate negotiate and approve the proposed settlement; (6) the lack of any independent and disinterested investigation and review of the claims and causes of action sought to be settled; and (7) the lack of any showing that the proposed settlement and related transactions were approved or authorized by the debtor in accordance with the debtor's corporate charter documents and the relevant state law corporate formalities and requirements. *See, e.g., In re The Present Co.,* 141 B.R. 18 (Bankr. W.D.N.Y. 1992) (concluding settlement was not above the lowest point of reasonableness where the settlement was not the result of arms-length bargaining by a disinterested party and the creditors' committee was not a party to the bargaining that yielded the compromise); *In re Matco Electronics Group*, 287 B.R. at 68 (denying approval of debtors' proposed settlement where settlement was not proposed by disinterested party and provided for the releases of the same individuals who signed it).

Finally, the committee may also want to argue that the proposed settlement is an attempt to circumvent the procedural safeguards of Chapter 11 and the Bankruptcy Code.[4] Since the debtor's proposed settlement will likely attack the merits of the committee's claims and causes of action, the committee should also emphasize in its objection that it is not the committee's burden to establish that it will prevail with its proposed claims, but rather, the burden is on the debtor to persuade the court that its proposed settlement is fair, reasonable and in the best interests of the debtor's estates. In doing so, the committee should also highlight the fact that if such claims and causes of action were truly unsupported and without merit, the committee would not have been granted the authorization by the court to commence such claims from the start. The creditors' committee should emphasize the factors that support keeping its claims and causes of action alive by showing: (a) the sufficient likelihood of substantial recovery that would result from its action justifies the continued prosecution of such action, and that any delay would not be material; (b) trial preparation and trial of the action would not require additional expenditures that would make such action economically unfeasible to bring to trial; (c) the only parties who support the settlement are the debtor, the settling parties, and their counsel, while the creditors' committee, representing the true stakeholders of the case, whose views are disinterested and are the result of an in-depth investigation and analysis of the claims and causes of action at issue, vehemently objects to the proposed settlement; and (d) the committee's claims and causes of action are *bona fide*, colorable and serious, and will result in adding substantial value to the debtor's estate and creditors and therefore, the best interest of the debtor's estate requires the continued prosecution of the committee's action. *See Hydronic Enterprise*, 58 B.R. 363 (Bankr. D.R.I. 1986) (denying proposed settlement where continued prosecution of action at issue would inure to the benefit of creditors); *Neshaminy Office Bldg. Assocs.*, 62 B.R. at 804 (concluding lower court approved a compromise without sufficient evidentiary basis for an independent assessment of reasonableness where settlement proponent failed to present sufficient evidence for a court to conclude that the compromise was in the debtor's best interest); *In re Spielfogel*, 211 B.R. at 147 (rejecting proposed settlement as not meeting the standards of being fair and equitable and in the best interest of the debtor's estate); *In re The Present Co.*, 141 B.R. at 24 (disapproving proposed compromise where there was no investigation by disinterested party or arms-length bargaining and concluding compromise was not above the lowest point of reasonableness).

<u>Plan Ahead and Include Specific Protections in the DIP Orders and/or Cash Collateral Orders</u>

Another way for a creditors' committee to protect itself from any non-consensual settlement of its claims and causes of action by a debtor is to negotiate and include specific language in the DIP order and/or cash collateral order providing that the debtor not only agrees to waive its right to commence any claim or cause of action against its pre-petition lender(s), but it also agrees to waive any right to settle or compromise any action that may be commenced against its pre-petition lender(s) by the committee or other third party.

<u>Include Specific Language in the Authorization Order</u>

If the committee is unable to have the specific language set forth above included in the DIP order and/or cash collateral order, whether it is because it is too late or because other parties, including the debtor and/or the lenders, do not agree to such language, the committee should include such language in the order that authorizes the committee to commence such actions as an estate representative.

Conclusion

Although on its face, Section 1123(b)(3)(A) of the Bankruptcy Code seems to suggest a debtor can propose a settlement of an action brought by a creditor's committee without the committee's consent, a debtor must still be able to satisfy the standards under Rule 9019 in order to have its settlement approved by the bankruptcy court. A creditors' committee can also protect itself and avoid the situation whereby the debtor attempts to settle an action commenced by the committee without the committee's consent by planning ahead and protecting its rights early on in the case by including specific language in the cash collateral orders and/or DIP orders and the orders authorizing the committee to commence claims and causes of action as an estate representative.

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4 A settlement may have such far-reaching consequences that an issue that may arise is whether the settlement is being proposed to bypass the creditor protections afforded by the Bankruptcy Code *via* the confirmation process in the form of a *de facto* or "*sub rosa*" plan of reorganization. "Upon timely objection, the court is to consider whether a settlement is a *de facto* plan of reorganization and thus [satisfies] the procedural protections of Chapter 11 of the Bankruptcy Code." *See In re Lion Capital Group*, 49 B.R. at 175. The creditors' committee should also determine whether the debtor's proposed settlement dictates the conclusion and outcome of the Chapter 11 proceedings, and if so, demand that the debtor be required to embody the terms of its settlement in a plan of reorganization to be voted on by all of the debtor's creditors. The proposed settlement may also have the effect of dictating the terms of any future liquidating plan by impermissibly restructuring the rights of the debtor's unsecured creditors and providing for the release of all claims and causes of action by all parties against the debtor and its estate and the proposed settling parties, thereby effectively ruling on the allowability of such claims. While the standards for approval of a settlement or compromise of controversy differ from those of confirmation of a plan, where there exists numerous creditors holding substantial claims against the debtor's estate whose interests may not have been adequately represented in the negotiations of the debtor's proposed settlement, the committee should argue that the debtor should not be permitted to short-circuit the requirements of Chapter 11 and the statutory plan confirmation process in an effort to effectuate an extraordinarily broad Rule 9019 settlement and bind creditors without providing all creditors the protections intended by Chapter 11, such as proper disclosure, claims allowance and voting safeguards of the Chapter 11 plan confirmation process. *See In re Louise's, Inc.*, 211 B.R. 798, 802 (D. Del. 1997) (denying debtor's motion to approve its proposed settlement, after concluding, among other things, that the proposed settlement contained provisions that would have the effect of circumventing a meaningful consideration of the requirements of Chapter 11 regarding confirmation of a plan).

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Buccino & Associates, Inc.

Roy Messing
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Raymond Peroutka
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Stephen Perrella
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Ben Eakes
Prophet Equity

Jordan Fisher
Alvarez & Marsal

John Lippmann
FTI Consulting

Douglas Main
Deloitte

Harold Perry
Real Globe Advisors, LLC

Isaac Pino
Deloitte FAS LLP

Stephen Salantrie
J.H. Cohn LLP

Colin Wittmer
PricewaterhouseCoopers LLP

MEMBERS ON THE MOVE

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

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ANNOUNCEMENTS

If you would like to post an announcement in the AIRA Journal please email aira@aira.org for more information.

Bankruptcy Analyst, GS-301-13/14

VACANCY ANNOUNCEMENT NUMBER: DELA-BA-0302

WHO MAY BE CONSIDERED: Applications will be accepted from U.S. citizens and nationals. You need not be a current or former Federal employee to apply.

THIS IS A FULL-TIME, PERMANENT, EXCEPTED SERVICE APPOINTMENT

JOB SUMMARY: The U.S. Trustee Program (USTP) is a component of the Department of Justice and has the legal authority to appear in every bankruptcy case filed in the United States, from chapter 7 liquidations to major chapter 11 business reorganizations. As a result, USTP employees headquartered in Washington, D.C., and in our 95 field offices throughout the country handle a wide range of challenging and significant matters as we strive to promote the integrity and efficiency of the bankruptcy system by enforcing bankruptcy laws and providing oversight of private trustees. Of particular importance is this Program's efforts to address fraud and abuse by debtors, creditors, attorneys, and others in the bankruptcy system by taking formal and informal actions in a civil context and making criminal referrals to and working with the U.S. Attorneys. If you are interested in a challenging and rewarding career and access to a generous benefits package, consider the USTP as your employer of choice! DOJ has been ranked in the Top 5 Best Places to Work in Federal Government for 2007. See www.bestplacestowork.org.

DUTIES: The incumbent applies economic and financial analysis skills to the administrative supervision of bankruptcy cases filed by businesses and consumers primarily under chapters 7, 11, 12 and 13 of the Bankruptcy Code. Reviews debtor's bankruptcy petitions and schedules, business records, periodic financial reports and any proposed reorganization plan for technical sufficiency and to determine financial viability of the business. Recommends appropriate action to either the United States Trustee or Assistant U.S. Trustee. Facilitates the formation and operation of creditor's committees and participates in examination of the debtor. Examines financial reports and operating statements. Assists in the development of operational guidelines, reporting forms, procedures and policies. Participates in oversight of Trustees by review of reports, case files, and audits. May assist in preparation of variety of motions and judicial pleadings.

QUALIFICATIONS: Certified Public Accountant (CPA) certification (or CIRA) and /or a BA/BS which included or was supplemented by 24 semester hours in accounting is preferred. An MBA would also be considered. A 'hands on' accounting background is desirable as well as skill with computer spreadsheets, financial statement analysis and forensic and investigative accounting and auditing. Also, a small business background is preferred.

CLUB 10

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

FTI Consulting Inc	**71**
Alvarez & Marsal LLC	**48**
AlixPartners, LLP	**47**
Deloitte.	**30**
Grant Thornton LLP	**25**
Zolfo Cooper	**23**
Huron Consulting Group LLC	**20**
KPMG LLP	**20**
LECG LLC	**18**
Capstone Advisory Group LLC	**17**
Mesirow Financial Consulting LLC	**15**
Navigant Capital Advisors LLC	**15**
BDO Seidman LLP	**13**
CRG Partners Group LLC	**13**
DLC Inc.	**13**
PricewaterhouseCoopers LLP	**12**
Protiviti Inc	**12**
J H Cohn LLP	**10**

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