AIRA Association of Insolvency & Restructuring Advisors

Journal

News from the Association of Insolvency & Restructuring Advisors

Volume 26, Number 2

ALSO IN THIS ISSUE

Road Map to Successful Turnaround: There's No Easy Path

Gina Gutzeit, *CIRA, FTI Consulting, Inc.*
Scott Rinaldi, *FTI Consulting, Inc.*

Dozens of large companies find themselves experiencing financial distress each year even in favorable economic climates. The precise reasons that companies wind up in poor financial health are as varied as the companies themselves but generally can be attributed to a flawed business model, strategic errors or missteps, improper or poor execution, unanticipated actions of competitors, or a detached and ineffective senior management team, to name a few.

Over the last decade, the field of turnaround management has attracted a wide range of practitioners and approaches to address poorly performing and faltering companies. Unfortunately, many turnaround approaches and strategies ultimately are ineffective; they are too short term in nature and can serve to thwart the turnaround effort in the long run. A common plan, especially since the 2008 financial crisis, is to focus exclusively on "fixing the balance sheet" and improving access to capital. How often have we heard the expression "*good company/bad balance sheet*"? That phrase is simplistic nonsense. A "finance-first" approach is shortsighted at best and futile at worst. It is tantamount to treating a symptom. Capital structures that are unsustainable rarely, if ever, start off that way; rather, it is operating deterioration that eventually causes debt obligations to become unbearable. Nearly every instance of corporate financial distress and failure is rooted in operations. Notwithstanding the effects of the recent global credit crisis, a majority of distressed companies are facing challenges well beyond the soundness of their balance sheet. Recapitalization undoubtedly is effective for shoring up finances quickly but does little to promote a successful turnaround, improve long-term cash flows and ensure operational sustainability.

Both major credit rating agencies recently have turned their attention to distressed debt exchanges (what we would consider out-of-court restructurings) that subsequently default within a few short years of implementing an exchange. Empirical studies of such events suggest that approximately 25 percent to 40 percent of companies that complete distressed debt exchanges go on to default within less than five years, either through a bankruptcy filing or a subsequent distressed exchange. These transactions, in many instances, bide time but little more.

When it comes to turning around an unhealthy company, there are several other areas of concentration that we believe will increase significantly the likelihood of long-term success. These areas require management, with the assistance of a turnaround practitioner, to identify, assess and clearly articulate the company's competitive advantages and transform the corporate culture while keeping a keen focus on endgame goals and maintaining consistent communication and messaging. This article provides an explanation of some areas we believe can restore competitiveness, sustainable long-term profitability and, we hope, market leadership. We also highlight some common pitfalls that management teams and practitioners should be mindful of when navigating a turnaround situation.

Competitive Advantage

Despite its outward optimism and best intentions, a senior management team cannot simply decree an operational turnaround. Even a brilliant turnaround team cannot turn a laggard into a market leader without some essential ingredients. A company's competitive advantage must be identified and impartially evaluated. Only then can management determine if a turnaround is feasible or if other alternatives should be considered (e.g., liquidation, sale). If there is no distinct competitive advantage on which to build a realistic business plan upon which a turnaround strategy can be based, then an operational recovery may not be attainable. If a sustainable turnaround is not possible, recognizing this fact quickly is critical to minimizing additional financial losses and enterprise value erosion.

If a competitive advantage does exist, then it must become the foundation of the management team's turnaround plan and long-term corporate strategy. Making a competitive advantage the core focus

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

A Letter from the President

Anthony V. Sasso, CIRA
Deloitte Financial Advisory Services LLP

Hello fellow members and friends of the AIRA. Today, I would like to highlight two upcoming AIRA events. The first is the Opening Reception at the 86th Annual NCBJ Conference, and the second is the AIRA 11th Annual Advanced Restructuring & Plan of Reorganization Conference in New York ("New York POR Conference").

NCBJ 2012 Opening Reception Sponsored by AIRA

The 86th NCBJ Annual Conference takes place this October 24-27 at the San Diego Marriott Marquis Hotel & Marina, located on San Diego Bay. As in prior years, the AIRA will again host the Opening Reception, which will take place in the Marriott's San Diego Ballroom – North Tower on October 24th from 5:30 to 7:30 pm. For all those attending the NCBJ this year, please remember to stop by for this outstanding networking opportunity. For those who have not attended this event in prior years, the NCBJ opening reception usually attracts in the neighborhood of 1,000 guests. I encourage you to take this opportunity to catch up with colleagues and friends, chat with one or two of the many honorable bankruptcy judges who will be in attendance, enjoy some great appetizers and indulge in a cocktail or two—and don't forget to visit the corporate sponsor booths to gather up some useful giveaway items and thank them for their support.

AIRA's 11th Annual New York POR Conference

This year's Advanced Restructuring & Plan of Reorganization Conference in New York takes place on November 19th at the Union League Club, 38 East 37th Street, New York NY. Since the inaugural year in 2002, we have had the good fortune to have some of the best and brightest Federal Bankruptcy Judges speak on our panels at this all-day event. This year promises to be no different. More details will be coming soon, but mark your calendars for November 19th and plan to be there for a remarkable forum on significant events impacting our profession during the past year and going forward. Fringe benefits include up to eight hours of CPE credit and a post-conference cocktail reception where there will be an opportunity to say hello to your favorite judge in an informal setting. Also, at the reception we will recognize Honorable Mary F. Walrath, Bankruptcy Judge for the District of Delaware, for her distinguished service to the bench. I hope to see you there for what will surely be an informative and enjoyable experience!

Tony Sasso

Anthony Sasso

Executive Director's Column

Grant Newton, CIRA
AIRA Executive Director

Fee Enhancement by Financial Advisors: Fifth Circuit Decision in *Pilgrim's Pride*

Financial advisors cannot generally be employed by a trustee, debtor in possession or creditors' committee except upon an order of court expressly fixing the amount of compensation or rate by which it is to be measured. Generally financial advisors are retained under Bankruptcy Code sections 327(a), 328(a), 363 (in conjunction with a sale of assets or businesses), or 1103 (by creditors' committee) to provide financial advisory services for debtors, trustees or committees with the court's approval. Under section 328(a) financial advisors and other professionals may obtain approval of a compensation agreement from the court in advance of rendering services with some degree of assurance that the amount of compensation will not be modified by the court, unless it is proven the amount was improvident in light of developments not capable of being anticipated. Financial advisors and other professionals may also receive a success or completion fee, often at the conclusion of the proceedings. Generally, what constitutes the success or completion fee is defined in the retention order.

Section 327(a) of the Bankruptcy Code provides that with the court's approval the trustee or debtor in possession "may employ one or more attorneys, accountants, appraisers, auctioneers, or other professional persons...to represent or assist the trustee [or debtor in possession] in carrying out the trustee's duties under this title."

Financial advisors may be retained in conjunction with a potential sale of the business or substantially all of the assets. The following factors apply to retentions related to a section 363 sale:

- Courts may allow compensation different from the compensation provided if terms and conditions prove to have been improvident in light of developments not capable of being anticipated at time of fixing such terms and conditions.
- Under section 328(a), professionals may obtain approval of a compensation agreement from the court in advance of rendering services.
- The amount of compensation approved will not be modified by the court unless it is proven the amount was "improvident in light of developments not capable of being anticipated . . ."
- In addition financial advisors may also receive a success or completion fee, often at the conclusion of the proceedings.
- Generally fee enhancements must be approved in the retention order and must define what constitutes a success or completion fee.
- This requirement also applies to an accountant or financial advisor employed by a debtor in possession.

In *In re Pilgrim's Pride Company*[1] the Fifth Circuit court considered whether the Supreme Court's decision in *Perdue v. Kenny A. ex rel Winn*,[2] which curtailed the authority of district courts to award fee enhancements in federal fee-shifting cases, overruled the Fifth Circuit's precedent in the bankruptcy arena. The court ruled that it did not do so, affirming the bankruptcy court's decision to award fee enhancements.

In December of 2008, Pilgrim's Pride Company and six of its affiliates filed for protection under chapter 11. According to the Fifth Circuit the debtors' prospects for a successful reorganization were far from promising at the filing date. Pilgrim's Pride and its affiliates had lost approximately $1 billion in the fiscal year preceding their bankruptcy filing and were operating at a negative annual cash flow of over $300 million. The expected result was that unsecured creditors would at best receive a debt-for-equity swap and equity holders would not receive any value for their investment. The bankruptcy court observed, "CRG was highly effective throughout th[e] [restructuring] process and facilitated a number of changes, including the replacement of certain executive officers and the development and implementation of a new business model."[3] The bankruptcy court also noted that with CRG's assistance the Debtors prepared a bankruptcy plan that was confirmed by the bankruptcy court on December 10, 2009, just over a year after the petition date. The plan provided for a 100 percent return to all of the Debtors' secured and unsecured creditors, and the Debtors' prepetition shareholders received $450 million in new equity interests.

After the plan was confirmed CRG sought the bankruptcy court's approval of $5.98 million in fees calculated in accordance with the lodestar method. CRG also requested approval of a $1 million fee enhancement that the Debtors' board of directors had recommended to be paid to CRG. No party objected to the $5.98 million fee request and it was approved by the bankruptcy court. The United States Trustee did object, however, to the $1 million fee enhancement, "acknowledging the excellent performance of CRG but nevertheless asserting that CRG had already received adequate compensation."[4] No other party filed an objection to CRG's request for a $1 million fee enhancement.

After holding an evidentiary hearing the bankruptcy court found that CRG had provided superior services which contributed to the outstanding results in the Debtors' bankruptcy case; however, the bankruptcy court denied CRG's enhancement request because CRG failed to satisfy the strict requirements of the Supreme Court's 2010 holding in *Perdue*, 130 S. Ct. at 1662.

CRG appealed the decision to the district court, which held tthe bankruptcy court erred in treating the federal fee-shifting decision in *Perdue* as binding authority in a bankruptcy proceeding.[5] The

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1 2012 U.S. App. LEXIS 16702 (5th Circuit)
2 130 S. Ct. 1662 (2010).
3 *CRG Partners, LLC v. U.S. Tr.*, 445 B.R. 667, 668 (N.D. Tex. 2011).
4 *Id* at 668.
5 *CRG Partners*, 445 B.R. at 672-73.

district court noted that "[i]t is one thing for a court to seek guidance from a case decided in a different context; it is another thing entirely for a court to allow such a case to displace its previously-established precedent."[6] The district court reversed the bankruptcy court's decision and remanded the case for further proceedings.[7]

On remand, the bankruptcy court relied on its prior decision in *In re Mirant Corp.*, 354 B.R. 113 (Bankr. N.D. Tex. 2006), which held that four specific factors must be satisfied in order for a professional to receive an enhancement pursuant to 11 U.S.C. § 330(a). The bankruptcy court awarded CRG the $1 million fee enhancement after finding that it had met all four *Mirant* factors. The bankruptcy court then certified its order for direct appeal to this court, and we granted the parties' motions for leave to appeal the order pursuant to 28 U.S.C. § 158(d)(2). Listed below are the four factors considered in *Mirant:*

1. No objections have been lodged against the applications for fees.
2. The case results have been stunningly successful.
3. The results are consistent with the general intent of chapter 11; that is, one that approximates the fair and equitable standard.
4. Applicants have satisfied the requirements of section 330 of the Bankruptcy Code.

The Trustee has raised one issue on appeal, contending the district court erred in reversing the bankruptcy court because *Perdue* narrowly circumscribed the bankruptcy court's discretion to grant fee enhancements. The Trustee requests that reversal of the bankruptcy court's order under *Mirant* and "[reinstatement of] the bankruptcy court's order entered on June 21, 2010, denying the requested bonus under *Perdue*."

CRG countered that *Perdue* was not intended to upend the settled precedent concerning fee enhancements in bankruptcy proceedings. CRG requests affirmation of the bankruptcy court's order under *Mirant* because "*Perdue* does not control fee enhancement requests in bankruptcy cases."

According to the Fifth Circuit, the question thus becomes whether *Perdue* unequivocally, *sub silentio,* overruled the bankruptcy framework, which currently permits bankruptcy courts to: (1) consider the *Johnson* factors after calculating the lodestar; and (2) award fee enhancements in situations that fall outside of the three specific circumstances set forth in *Perdue*. The Fifth Circuit note that it began its analysis with the obvious: *Perdue* is a federal fee-shifting case. *Perdue*.[8] The Court made this clear at the outset of the opinion and relied solely on its prior fee-shifting jurisprudence to support its holding.[9] The opinion neither explicitly touched on bankruptcy law nor indicated that the Supreme Court intended *Perdue* to extend to non-fee-shifting cases. The Fifth Circuit took the Supreme Court at its word when it described *Perdue* as a federal fee-shifting case, and declined to extend it further.[10]

The Fifth Circuit also noted that "[t]his lack of intent to extend *Perdue* is evidenced, for instance, by the fact that the three circumstances justifying a fee enhancement are essentially non-existent in the bankruptcy arena because they are already addressed by the Bankruptcy Code. Section 331 of the Bankruptcy Code enables professionals to request fee awards and expense reimbursements "every 120 days . . . or more often if the court permits," and to receive disbursements after notice and a hearing.[11] The Fifth Circuit also noted that "This provision eliminates the prospect that there could be either an "extraordinary outlay of expenses" or the "exceptional delay in the payment of fees" during a bankruptcy proceeding[12] and requires courts to consider whether "compensation is reasonable based on the customary compensation charged by comparably skilled practitioners in cases other than cases under this title."[13] ■

6 *Id.* at 672.
7 *Id.* at 673.
8 130 S. Ct. at 1672.
9 *See Id.*at 1669, 1672-75.
10 *See Id,* at 1669; *see also Technical Automation*, 673 F.3d at 407.
11 11 U.S.C. § 331.
12 *See Perdue*, 130 S. Ct. at 1674-75.
13 11 U.S.C. § 330(a)(3)(F).

MEMBERS IN THE NEWS

Daniel Ventricelli, CIRA, to Manage Litigation & Fraud Investigation Practice for BDO's New York Office

BDO Consulting announced in August the growth of its Litigation & Fraud Investigation practice with the addition of **Daniel Ventricelli, CIRA**, as a Managing Director in the New York office.

CIRAs Comprise New Energy-Based Restructuring Group with Charles River Associates in Houston

In August **Loretta Cross, CIRA, CDBV**, joined Charles River Associates (CRA) as Vice President in its Energy & Environment Practice in Houston. Joining Ms. Cross to create the new energy restructuring team are Principal **Robert S. Moore II, CIRA**, and Associate Principal **John Baumgartner, CIRA**.

Reinstatement of Debt: Having Your Cake and Eating It, Too[1]

Daniel P. Winikka & Paul M. Green, *Jones Day*

A substantial amount of debt was raised over the last several years at near historically low interest rates and in many cases with minimal financial and other restrictive covenants. As a result, a potential restructuring strategy for many companies that continue to be overleveraged involves the use of the bankruptcy process to restructure a company's "bad" debt (i.e., debt with above-market terms) or debt with maturities in the near term, while simultaneously using the Bankruptcy Code's reinstatement provisions to retain valuable credit with below-market terms. Such a strategy may be particularly appealing when the pricing of credit risk increases substantially, as it did following the financial crisis in late 2008.

Reinstatement requires that pre-bankruptcy defaults (other than defaults based solely on the bankruptcy filing or the debtor's financial condition pre-bankruptcy) be cured and that the debtor thereafter comply with all requirements and covenants under the applicable loan documents. Not surprisingly, the battleground over reinstatement plans is typically the issue of whether non-monetary defaults can be cured or whether covenants will be breached following, or as a result of, consummation of the restructuring plan.

Cases involving reinstatement disputes following the 2008 financial crisis have demonstrated, however, that courts may be willing to narrowly construe covenants to permit a debtor to reinstate debt to achieve a restructuring. In addition, these cases suggest that a technical covenant default may be insufficient to defeat reinstatement absent the lender providing a cogent explanation for why the lender is not receiving the benefit of its original bargain.

Requirements for Reinstatement

When an event of default occurs, a lender typically has the right to accelerate the loan and exercise remedies to collect on the total amount of its outstanding debt. By reinstating debt as part of the bankruptcy process, debtors obtain a unique opportunity to de-accelerate the prepetition loan and continue with the original terms and maturities, all without obtaining the lender's consent.[2] To succeed in reinstating the original terms, however, the debtor must cure prepetition defaults and not otherwise alter the legal, equitable or contractual rights of the lender.

Specifically, to reinstate a prepetition obligation under a plan of reorganization, a debtor must: (1) cure any prepetition defaults (other than ipso facto defaults or defaults that relate to the financial condition of the debtor prior to or during the bankruptcy case); (2) compensate the lender for any damages incurred as a result of reasonable reliance on the acceleration of the obligation; (3) compensate the lender for any actual pecuniary loss arising from the failure to perform a nonmonetary obligation; and (4) ensure that the plan does not "otherwise alter the legal, equitable or contractual rights" of the lender. 11 U.S.C. § 1124(2). Notwithstanding that the plan alters the lender's rights by preventing the lender from using a contractual right of acceleration, if the reinstatement requirements are satisfied, the lender's claim will be deemed unimpaired and the lender will be deemed to have accepted the plan. 11 U.S.C. § 1126(f).

Reinstatement thus requires that the reorganized entity comply with all financial covenants following consummation of the plan. Such covenants may include requirements to maintain certain financial ratios or a certain level of earnings (typically a certain level of earnings before interest, taxes, depreciation and amortization or "EBITDA"). In addition, consummation of the plan itself cannot result in a breach of covenants under the loan documents. Potentially problematic covenants may include restrictions on a change in control or restrictions on divestitures without consent and application of proceeds to pay down the debt. As a result, reinstatement may not be a viable strategy in situations requiring a significant operational restructuring (as opposed to a financial restructuring solely to deleverage the balance sheet). For example, if lines of business will be sold or shut down, there may be an inability to meet financial covenants set on the premise of a much larger operation, and sale proceeds may not be available as a source of capital. The feasibility of a reinstatement plan may also be an issue, particularly if the debtor's projections show there is little cushion in its ability to meet financial covenants in the future or there is a question about the ability of the debtor to pay or refinance the reinstated debt at maturity.

From a lender's perspective, reinstatement may undermine an expectation that a default will provide an opportunity to renegotiate to prevailing market terms. In fact, because of the inability to renegotiate to current market rates, lenders may view reinstatement of their debt as the functional equivalent of a coerced loan. Notwithstanding what may have been the lender's expectations in the event of a default and perhaps a substantial delay in payment, the policy underlying reinstatement is that the lender in essence receives the full benefit of its original bargain.

Indeed, while disputes over reinstatement plans often involve issues about technical compliance with covenants, outcomes will likely depend upon whether the court is convinced the lender is in essence receiving the benefit of its original bargain. Two recent decisions involving reinstatement, Charter Communications and Young Broadcasting, demonstrate the critical role played by the assessment of whether the lender is in essence receiving the benefit of its bargain. The contrasting outcomes in these two cases, which involved very similar issues, likewise provide valuable lessons on issues associated with reinstatement.

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1 Reprinted with permission from *Pratt's Journal of Bankruptcy Law*.

2 In addition to de-accelerating the debt, reinstatement effectively allows a debtor to "roll back the clock to the time before the default existed." MW Post Portfolio Fund Ltd. v. Norwest Bank Minn., N.A. (In re Onco Inv. Co.), 316 B.R. 163, 167 (Bankr. D. Del. 2004). In Onco, for instance, the ability to roll back the clock permitted the debtor to de-accelerate the debt both for itself and its non-debtor affiliates. *Id.*

Charter Communications

At the time of its bankruptcy filing, Charter Communications was the country's fourth largest cable television company. Prior to bankruptcy, Charter devised a restructuring strategy premised on reinstating its senior debt to take advantage of a favorable interest rate and negotiated a deal with its junior bondholders to convert their debt to equity.[3] Ultimately, the bondholders agreed to convert their bonds into equity, while backstopping a rights offering to raise additional capital. A key component of the transaction included the reinstatement of the senior debt to take advantage of favorable credit terms.[4]

A central issue in Charter was the interpretation of a change in control provision in the credit agreement that required Paul Allen, the controlling shareholder of Charter, to retain at least 35% voting power over Charter's board of directors.[5] The change in control provision also required that no person or group could have more than 35% of the voting power unless Allen had a greater percentage of voting power. To avoid triggering a default of the change of control provision and to preserve valuable net operating losses, the prepackaged plan proposed a settlement with Allen, pursuant to which he would retain 35% of the voting power over Charter's board and receive approximately $375 million in cash and other consideration, but would retain no meaningful ongoing economic interest in the reorganized Charter. Allen's willingness to participate in the settlement was critical to the debtors' plan because it preserved the terms of the senior debt—estimated to save hundreds of millions of dollars—as well as $2.85 billion in net operating losses.[6]

In an attempt to prevent the deal, JP Morgan Chase Bank, as agent for the senior lenders, objected to the debtors' plan on the basis that, among other things, the plan would violate the credit agreement's change of control provisions.[7] With regard to the agreement's change of control provisions, the lenders advanced two specific arguments. First, they asserted that the credit agreement required Allen to retain an ongoing economic interest, in addition to the retention of a 35% voting interest. Second, the lenders argued that four of the bondholders, which the lenders dubbed the "Takeover Group," constituted a "group" under the Securities and Exchange Act with more than 35% of the voting rights—in violation of the change of control provision.[8]

The Court acknowledged that "no one seriously disputes that Mr. Allen is walking away from his investment in Charter and is agreeing to maintain his voting power as a structuring device that benefits Charter and its stakeholders."9 To determine whether the credit agreement required Allen to retain an economic interest in the reorganized company, the court analyzed the precise language of the underlying agreements. The Court found that the requirement that Allen have not less than 35% of the ordinary voting power did not require that he likewise have a commensurate ongoing economic interest. This conclusion was bolstered by the fact that the credit agreement had previously contained an economic interest requirement that had been eliminated when the agreement was amended to reduce the voting requirement from 51% to 35%.[10]

The more difficult question for the court was whether the bondholders, which would hold over 38% of the stock of reorganized Charter, constituted a group. The court pointed out that no one had "offered a c ogent explanation as to the practical importance of the covenant that went beyond its mere existence and mandated technical requirements" and that "it is difficult to discern how a slight variation in the percentages, one way or the other, could have any impact on the credit risk of the borrower."[11] The court concluded that the covenant should be construed narrowly so as to enable the debtor to engage in a permissible corporate restructuring.[12] In line with this narrow interpretation, the court found that the Takeover Group would not constitute a "group" for purposes of the credit agreement because there was no proof the bondholders had any actual agreement between them.[13]

Charter's success in reinstating its senior debt was due in part to Charter's careful prepetition planning, in which Charter avoided any obvious monetary defaults (bolstering the impression that the lenders have no real complaint) and the bondholders avoided entering into any formal prepetition agreements.[14] The debtors were also successful in framing a narrative for the court—namely, that the lenders' objections were largely based on the fact that the lenders were excluded from the prepetition discussions.[15] Finally, the lenders did not present convincing evidence that they would not receive the benefit of their original bargain with Charter.[16]

Young Broadcasting

Subsequent to Charter, another debtor, Young Broadcasting, followed a similar blueprint in an attempt to reinstate its senior debt. Young Broadcasting's bankruptcy case began as an asset sale, with a senior lender stalking horse bid ($220 million) substantially

3 *See In re Charter Commc'ns*, 419 B.R. 221, 231–32 (Bankr. S.D.N.Y. 2009) ("This complex enterprise is endeavoring with singular creativity and determination to reduce its heavy debt load and recapitalize itself during perhaps the most challenging period in the modern era or global corporate finance.").

4 *See id.* at 232–33 ("[Charter's restructuring advisor] was behind the decision to engage in a high velocity negotiation with the bondholders while leaving the senior debt in place to take full advantage of favorable pricing applicable to the existing senior indebtedness.").

5 *Id.* at 240.

6 *Id.* at 253-54. As part of the settlement, Allen agreed to forbear his prepetition exchange rights. This forbearance resulted in Charters' preservation of the NOLs. *Id.*

7 *Id.* at 248.

8 *Id.* at 248–49. The lenders were in essence contending that, in violation of the intent of the credit agreement, major bondholders would effectively be controlling the reorganized Charter rather than Paul Allen. As the Court described it, the "nominal retention of voting power has been attacked as a gimmick fashioned by corporate lawyers to obscure a takeover of the company by bondholders." *Id.* at 230.

9 *Id.* at 231.

10 *Id.*, 419 B.R. at 237-39.

11 *Id.* at 239.

12 *Id.*

13 *Id.* at 240, 249.

14 *See id.*, 419 B.R. at 231-33 (describing the process by which the plan was negotiated and drafted prior to bankruptcy).

15 *See id.* at 233 ("Parties who were not at the table during this process have become the main objectors to confirmation. . . . [T]hey openly admit that their goal here is to obtain an increased interest rate that reflects what would be charged for a new loan in the current market . . . .").

16 *See id.* at 234 ("The senior lenders have been paid everything that they are owed under the existing facility and have even received default interest during the bankruptcy cases.").

below the amount of the secured debt ($338 million). Before the sale was consummated, however, the debtors' businesses and cash flows began to improve. As a result, the court found that there were no longer exigent circumstances necessitating a sale outside of a plan process and required the sale to be handled as part of a reorganization plan.[17]

Both the debtors and the unsecured creditors' committee eventually proposed plans. The debtors' plan provided for: (i) an exchange of all the senior secured debt for equity; (ii) $1 million to be distributed to the general unsecured creditors; and (iii) equity warrants to noteholders accepting the plan.[18] In contrast, the committee's plan proposed: (i) reinstatement of the senior secured debt; (ii) $1 million to general unsecured creditors; and (iii) the noteholders would receive 10% of common stock and an opportunity to participate in a $45.6 million rights offering under which the noteholders could purchase a pro rata share of preferred stock and 80% of the common stock in the reorganized company.[19]

The debtors agreed to seek confirmation of the committee's plan in the first instance, and confirmation of their own plan would move forward only if the court denied confirmation of the committee's plan.[20] The lenders raised three primary challenges to confirmation of the committee's plan: (i) reinstatement was not permitted because the plan violated the credit agreement's change of control provision;[21] (ii) the plan was not feasible because the debtors could not demonstrate they could repay the reinstated debt upon maturity;[22] and (iii) the plan violated the absolute priority rule because Vincent Young, one of the debtors' founders, was receiving new equity on account of his existing ownership.[23]

Change of Control

As in Charter, a critical issue in the case was whether the committee's plan provisions violated the credit agreement's change of control provisions.[24] Specifically, the credit agreement required Young to retain control over at least 40% of the voting stock. To avoid triggering a default, the plan proposed to grant Young all of the Class B stock in the reorganized company, which shares would be entitled to cast over 40% of the total number of votes for the directors, but only permitted Young to elect one of the seven directors.[25]

Both sides cited the Charter opinion for support of their position. The committee argued that Charter stood for the proposition that so long as a plan allows for a "formalistic retention of control," there will be no default of change of control provisions, notwithstanding the shift in economic ownership. The lenders, on the other hand, argued that the structure in Charter actually complied with the credit agreement, as Allen retained the ability to control 35% of the board, whereas in the current case, Young may have 40% of the total number of votes, but could only control the ability to elect one of the seven directors.[26] The lenders further argued that they had bargained for the assurance that Young exert control over the board of directors.

The court sided with the lenders, holding that the benefit of the bargain and the plain meaning of the credit agreement required Young to have the power to influence 40% of the composition of the board—not simply the power to cast 40% of the total votes for directors.[27]

Feasibility

In addition to the issues associated with the change of control provisions, the lenders also argued that the committee's plan, which left the reorganized entity with over $300 million in secured debt, was not feasible because it was unlikely that the debtors would be able to pay or refinance their senior debt at maturity in three years.[28] In concluding that the committee plan was not feasible, the court found the valuation of the committee's expert based on a "novel" discounted cash flow analysis inadmissible and thus excluded his opinion that the debt could be satisfied at maturity through a sale.[29] The court also found that the debtors' projections the experts relied upon, which projected EBITDA to double in the following year, were "aggressive and unrealistic."[30]

Absolute Priority Rule

Finally, the lenders also succeeded in demonstrating that the plan violated the absolute priority rule because Young received new equity on account of his existing equity. While the lenders as a senior, unimpaired class had no standing to press this issue and none of the unsecured creditors objected on this basis, the court found that it had an independent duty to analyze the issue.[31] The committee, relying in part on the decision in Charter, argued that Young (like Allen) received new equity on account of his cooperation in the reorganization, and not on account of his existing equity.[32] The court disagreed, noting that in Charter the new value provided to Allen was found to be substantially outweighed by the benefits and savings to the debtor. In the current case, however, the court found that the committee failed to quantify the value of the reinstated credit agreement compared to the 10% economic interest to be distributed to Young.[33]

Conclusion

Both Charter Communications and Young Broadcasting provide important lessons for lenders and reinstatement plan proponents. As demonstrated in both cases, if possible a lender should provide and present a cogent explanation for why the proposed reinstatement fails to provide the benefit of the original bargain. The lenders in Charter Communications did not do so, perhaps leaving the court with an incentive to narrowly construe what was necessary to constitute a group in violation of the change in control covenant. In contrast, the committee in Young Broadcasting

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17 *In re Young Broad. Inc.*, 430 B.R. 99, 108 (Bankr. S.D.N.Y. 2010).
18 *Id.* at 109.
19 *Id.* at 109–10.
20 *Id.* at 106.
21 *Id.* at 112.
22 *Id.* at 128.
23 *Id.*, at 141.
24 *Id.* at 112.
25 *Id.* at 113.
26 *Id.* at 114.
27 *Id.* at 117.
28 *Id.* at 139.
29 *Id.* at 127–28.
30 *Id.* at 132.
31 *Id.* at 139.
32 *Id.* at 141.
33 *Id.*

took an overly technical approach to the voting control covenant, which permitted the lenders to argue, and the court to conclude, that the lenders were not getting the benefit of their bargain.[34] In fact, the committee had a less aggressive alternative to avoid violating the provision, but the court did not permit resolicitation with that alternative because of the plan's other failures.[35]

Lenders should be careful to avoid creating discoverable communications that might suggest their true goal is to drum up a covenant violation to prevent reinstatement and renegotiate the debt to prevailing market terms. In situations where nonmonetary covenant breach contentions are highly technical and there is not a good business rationale for the covenant or convincing explanation for why the lender is not receiving the benefit of its bargain, lenders may want to consider possible compromises. Debtors and creditors may be willing to offer improved economics in exchange for covenant modifications.

Plan proponents should be careful when structuring ways to avoid non-monetary defaults to preclude any argument that the lenders are failing to receive the benefit of the bargain. Debtors in particular should consider reinstatement as a component of a restructuring strategy before filing for bankruptcy—and should attempt to avoid all monetary defaults to bolster the case that the lenders are receiving everything they bargained for. If existing equity holders will be equity holders of the reorganized entity to comply with change in control restrictions, proponents should also work to secure support from other creditor classes to avoid giving lenders any cram down arguments.

Because of the need to continue to comply with covenants in the loan documents, the circumstances in which reinstatement is a viable strategy, and the flexibility in structuring a reinstatement plan where it is a viable strategy, can be limited. Nonetheless, reinstatement is an important restructuring tool that can provide debtors and junior creditors with a valuable source of capital, especially in an environment where the pricing of credit risk increases substantially. ■

34 *See, e.g., id.* at 113 ("The lenders contend that the Committee's manipulation of the votes allocated to the Voting Stock is an effort to circumvent the protections negotiated by the Lenders.").

35 *See id.*, 430 B.R. at 121 ("Under other circumstances, the Court might have allowed the Committee to re-solicit and more fully describe the suggested alternative proposed board structure. . . . In the context of these cases, however, and for the reasons that will be discussed in this Opinion, the Court does not reach the issue of whether the Committee should be afforded an opportunity to re-solicit its plan."). The court was not required to reach the issue of resolicitation due to the fact that the court was able to confirm an alternative plan (the Debtor's plan), which had been proposed in the event that the court did not confirm the Committee's plan. *Id.* at 106.

Daniel (Dan) Winikka *is a partner in the Dallas office of Jones Day and has over 15 years of experience representing debtors, creditors' committees, secured creditors, unsecured creditors, and acquirers in complex business restructuring and bankruptcy matters. He has substantial experience representing clients in a variety of industries in chapter 11 reorganizations and liquidations, complex bankruptcy-related litigation, and the sale of assets and businesses of entities in bankruptcy, including both debtors/sellers and third-party acquirers. He can be reached at dpwinikka@jonesday.com.*

Paul M. Green *is an associate in the Dallas office of Jones Day. He focuses on business restructurings, distress acquisitions and dispositions, and other bankruptcy matters. He has represented debtors, secured and unsecured creditors, asset purchasers, lenders, and other interested parties in complex business restructuring and bankruptcy matters. He can be reached at pmgreen@jonesday.com.*

The views presented in this article are the personal views of the author and do not necessarily reflect those of Jones Day.

Lender Beware: Eleventh Circuit Court of Appeals Allows TOUSA Decision to Stand

Alan R. Lepene, William H. Schrag, John F. Isbell, and Andrew L. Turscak, Jr.

On July 23, 2012, the Eleventh Circuit Court of Appeals slammed the door shut on the controversial TOUSA decision, when it denied a petition for en banc review by the full appellate court. With that denial, the Court of Appeals closed one chapter in the TOUSA litigation, but another one may be about to be opened.

Background

In October 2009, the court overseeing the TOUSA, Inc. bankruptcy cases in the Southern District of Florida (the "Bankruptcy Court") set off considerable alarm bells throughout the lending community when it unraveled a refinancing transaction as a fraudulent conveyance based upon, in primary part, the fact that certain subsidiaries of TOUSA, Inc. pledged their assets as collateral for a new loan that was used to repay prior debt on which the subsidiaries were not liable and that was not secured by those subsidiaries' assets. The Bankruptcy Court's pronouncement required the disgorgement of more than $403 million in payments received by the prior lenders, and the avoidance of liens encumbering the subsidiaries' assets that were given to the take-out lenders. On February 11, 2011, the lending community obtained short-term relief from this decision when the district court for the Southern District of Florida (the "District Court") reversed the Bankruptcy Court's holdings that (a) the TOUSA subsidiaries had not received reasonably equivalent value when they pledged their assets to the new lenders and (b) the prior lenders were entities "for whose benefit" the liens were conveyed. As of May 15, 2012, however, lenders could no longer rest easy, as the Eleventh Circuit Court of Appeals (the "Court of Appeals") reversed the District Court and reinstated the Bankruptcy Court's holdings on reasonably equivalent value and on the liability of the prior lenders, while remanding to the District Court for further proceedings regarding the propriety of the remedies and damages awarded by the Bankruptcy Court. On July 23, 2012, the Court of Appeals denied a petition for another review by the full appellate court, introducing the prospect for a potential further appeal to the United States Supreme Court.

The TOUSA Bankruptcy Cases

TOUSA, Inc., together with its numerous affiliates and subsidiaries (collectively, "Tousa"), was a large regional residential developer and builder. In July 2007, Tousa entered into a financing arrangement with a group of lenders (the "New Lenders") for the purpose of funding a litigation settlement with another group of lenders (the "Transeastern Lenders") that had previously provided separate financing for a failed joint venture involving certain Tousa entities.

Under the new financing, a number of Tousa subsidiaries (the "Conveying Subsidiaries"), which were not parties to the loans with the Transeastern Lenders, were named as borrowers on the New Lenders' loans. The Conveying Subsidiaries granted security interests and liens on certain of their assets as security for the new financing, and the settlement payment to the Transeastern Lenders was funded.

Not long after entering into the new lending arrangement with the New Lenders, the housing market in Florida (and elsewhere) took a decided turn for the worse (an "economic Pearl Harbor," according to one media report cited in the District Court opinion), freezing credit markets and drying up the pool of home buyers, which, in turn, doomed Tousa.

Tousa filed for bankruptcy protection in January 2008. Shortly thereafter, an official committee of unsecured creditors (the "Committee") was appointed, and in July 2008, the Committee brought a lawsuit on behalf of Tousa's bankruptcy estate against a number of prepetition secured creditors of Tousa, seeking, among other things, avoidance and recovery of substantial prepetition payments and lien interests under preference and fraudulent transfer theories. Included in the action were claims brought on behalf of the Conveying Subsidiaries against the Transeastern Lenders and the New Lenders for avoidance of alleged fraudulent transfers under 11 U.S.C. § 548 (the "Bankruptcy Code"), as a result of the 2007 financing and settlement payments.

"Tousa 1"[1]—In its complaint, the Committee alleged that the July 2007 transaction, including the settlement payment to the Transeastern Lenders, was an avoidable fraudulent transfer because the Conveying Subsidiaries were rendered insolvent as a result of the transaction and they did not receive "reasonably equivalent value" in return.

After a 13-day bench trial involving nearly two dozen witnesses and thousands of trial exhibits, the Bankruptcy Court issued a 182-page opinion, in which it held in favor of the Committee on all claims. Specifically, the Bankruptcy Court, among other things, avoided the obligations incurred by the Conveying Subsidiaries to the New Lenders (and the liens securing those obligations) as a fraudulent transfer, ordered the Transeastern Lenders to disgorge the majority of the settlement payment (approximately $403 million) received by the Transeastern Lenders, and ordered that damages, including the transaction costs for securing the new financing, the attorneys' fees and costs in seeking to unwind the transaction, and an amount equal to the decrease in value in the liens that were granted to the New Lenders (*i.e.*, the decrease in value of the assets) be paid from the disgorged funds prior to any of those funds being returned to the New Lenders.

"Tousa 2"[2]—In a harshly critical opinion, the District Court reversed the Bankruptcy Court's decision as to the Transeastern Lenders, holding that the transfers to the Transeastern Lenders were not avoidable under Bankruptcy Code section 548 and related provisions. First, the District Court held that the payment sought to be avoided was not a transfer of property of the Conveying Subsidiaries; thus, an essential element of Bankruptcy

Lender Beware *continues on p. 10*

1 *Official Committee of Unsecured Creditors of Tousa, Inc. v. Citicorp North America, Inc. (In re Tousa, Inc.)*, 422 B.R. 783 (Bankr. S.D. Fla. 2009).

2 *3V Capital Master Fund Ltd. v. Official Committee of Unsecured Creditors of Tousa, Inc. (In re Tousa, Inc.)*, 444 B.R. 613 (S.D. Fla. 2011).

Lender Beware *continued from p. 9*

Code section 548 could not be met. Instead, the proceeds of the new loans were property of the parent. Moreover, with respect to the alleged fraudulent transfers arising from the granting of liens in the Conveying Subsidiaries' assets, the District Court held that the Conveying Subsidiaries received reasonably equivalent value in return by way of corresponding direct and indirect benefits in the form of averting defaults under other obligations[3] and a likely bankruptcy, as well as substantial tax benefits and an opportunity to rehabilitate their businesses. The District Court neither accepted nor rejected the Bankruptcy Court's finding that the Conveying Subsidiaries were insolvent at the time of the transaction.

"Tousa 3"[4]—After losing at the District Court, the Committee appealed to the Court of Appeals. In its decision, the Court of Appeals reversed the District Court and affirmed the Bankruptcy Court's finding that the Conveying Subsidiaries received less than reasonably equivalent value when they granted liens in their assets. Further, the Court of Appeals found that the Transeastern Lenders were entities "for whose benefit" the liens were transferred in affirming the liability of the Transeastern Lenders.

In arguing that they were not the entity "for whose benefit" the transfers were made, the Transeastern Lenders maintained that such a ruling would impose "extraordinary" duties of due diligence on the part of all creditors accepting repayments, as any funds could conceivably be received by the debtor in the first instance as a result of a fraudulent conveyance. In addressing this concern, and using language that will undoubtedly be quoted in future lender liability litigation, the Eleventh Circuit stated: "But every creditor must exercise some diligence when receiving payment from a struggling debtor. It is far from a drastic obligation to expect some diligence from a creditor when it is being repaid hundreds of millions of dollars by someone other than its debtor."[5]

The Court of Appeals remanded to the District Court for further proceedings regarding the propriety of the remedies and damages awarded by the Bankruptcy Court. The liability of the New Lenders was not decided in this appeal. As mentioned, the Court of Appeals thereafter denied a petition for *en banc* review by the full Eleventh Circuit Court of Appeals.

The Broader Implications of *Tousa 3*: What Does the Future Hold?

Tousa 3 involved one subset of appeals arising out of multi-faceted transactions involving numerous borrower, guarantor and lender parties and replete with factual and legal intricacies and complexities. As such, its holding is, for now, limited to the precise transaction and factual findings, as upheld by one circuit court of appeals. Nonetheless, the reverberations of *Tousa 3* may be substantial and the implications far reaching.

For starters, the *Tousa 3* opinion directly undermines the common practice of subsidiaries incurring obligations for the benefit of their parents, which practice is premised, in part, on the theory that the total enterprise benefits from the obligations incurred by the individual members of the enterprise. Ultimately, it is likely that counsel for borrowers and guarantors will seek to exploit this holding further, by attempting to use this decision to limit the liability of other affiliated corporate borrowers (*i.e.*, parent and sister companies) and guarantors that do not directly receive benefits from financings.

Further, it is likely that *Tousa 3* will be used to expand the scope of fraudulent conveyance litigation to include additional creditors as entities "for whose benefit" a transfer is made, as "every creditor must exercise some diligence when receiving payment from a struggling debtor."[6]

Further ramifications will be felt if the Bankruptcy Court is ultimately affirmed by the District Court on the broad range of remedies that it ordered, including, among other things, the disgorgement of the funds paid to the Transeastern Lenders, the award of damages that allowed the Committee to retain from the disgorged funds the transaction costs of entering into the financing, the costs and attorneys' fees incurred in pursuing the fraudulent conveyance claim, and the diminution in the value of the liens for the period between the transaction closing date of July 31, 2007, and October 13, 2009. Under the Bankruptcy Court's ruling, all of these costs and damages would be paid prior to the return of the remaining disgorged funds to the New Lenders.

Given the broad and far reaching implications of *Tousa 3*, it is possible the Transeastern Lenders will file a petition for a writ of *certiorari* with the U.S. Supreme Court. While only a small percentage of such petitions are typically granted, Tousa 3 involves issues that could set it apart from other cases—among them the fact that *Tousa 3* arguably represents a departure from fraudulent transfer doctrine established in other circuits—potentially making it an attractive candidate for high court review.[7]

3 Tousa's operations were financed in large part by issuances of unsecured bond indebtedness and a revolving credit facility, under which most of the numerous Tousa entities were jointly and severally liable as borrowers, pledgors and/or guarantors. According to testimony at trial, had TOUSA, Inc. not settled with the Transeastern Lenders, defaults may have been triggered under the bonds and/or credit facility.

4 *Senior Transeastern Lenders v. Official Committee of Unsecured Creditors (In re Tousa, Inc.)*, 680 F.3d 1298 (11th Cir. 2012).

5 *Id.* at 39.

6 *Id.*

7 Another interesting issue not addressed by the Eleventh Circuit is the propriety of the standard of review applied by the Court of Appeals panel in light of the Supreme Court's recent decision in *Stern v. Marshall*, which, like *Tousa 3*, has generated considerable controversy. *Stern v. Marshall* concerns limits on the constitutional power of bankruptcy judges to enter final orders in non-core proceedings. *Stern v. Marshall*, ___ U.S. ___, 131 S. Ct. 2594 (2011). The standard of review employed by the Eleventh Circuit panel in *Tousa 3* was whether the Bankruptcy Court's findings of fact were clearly erroneous; applying this deferential standard, the Court of Appeals concluded the Bankruptcy Court's findings of fact were not clearly erroneous and thus affirmed the Bankruptcy Court's holding that the lenders were liable. In their petition for rehearing *en banc*, the Transeastern Lenders argued that under *Stern*, fraudulent transfer claims are non-core proceedings for which bankruptcy courts lack constitutional authority to enter final orders (*i.e.*, they only may issue proposed findings of fact and conclusions of law, subject to *de novo* review by the district court); consequently, in light of *Stern*, it was the District Court's opinion that was entitled to deference, not the Bankruptcy Court's. If, under *Stern*, the action should have been treated as a non-core proceeding, as asserted by the Transeastern Lenders, the appropriate standard of review would have been for the Court of Appeals to have determined if the District Court's findings of fact in favor of the lenders were clearly erroneous (or to remand to the District Court to make such findings of fact). Had that standard of review been employed in *Tousa 3*, the outcome might have been altogether different.

The Transeastern Lenders still have time to consider whether to appeal to the nation's highest court. Whether they will do so and whether the important issues highlighted by *Tousa 3* will gain traction in further proceedings in the Supreme Court remains to be seen.

Until there is further clarity on all of these issues, lenders will need to be guarded with respect to transactions that involve facts similar to those present in the Tousa case. ■

Alan Lepene, Bill Schrag, John Isbell, *and* ***Andy Turscak*** *are members of Thompson Hine LLP, resident in its Cleveland, New York, and Atlanta offices. They can be reached at:*

Alan.Lepene@ThompsonHine.com

William.Schrag@ThompsonHine.com

John.Isbell@ThompsonHine.com

Andy.Turscak@ThompsonHine.com

There's No Easy Path *continued from p. 1*

within the organization is the most effective way of realizing its benefits. Equally important is incorporating competitive advantage into management's corporate vision after the company has successfully completed the turnaround and achieved sustainable financial health. Further, this path to a steady state must be articulated as specifically as possible and should be driven by competitive considerations and a healthy respect of market forces, not financial engineering.

We believe a successful turnaround depends entirely on a company's ability to define its competitive advantages and incorporate them into a strategy that is consistent with its long-term corporate mission. So what exactly is a competitive advantage? It is a distinct advantage or niche that a company possesses in its marketplace. A competitive advantage is why customers choose to do business with one company over its peers.

In its most basic terms, competitive advantage is a quality that you have that another business lacks. Examples of competitive advantage may include:

- Skills advantage
- Intellectual property
- Strategic partnerships
- First mover position
- Unique know-how
- Strategic locations or territories

Once a competitive advantage is defined, it must become the foundation of the company's turnaround strategy and needs to be aggressively communicated internally. A competitive advantage should come to define the company's success over time.

Corporate Culture

Culture is a powerful force influencing turnaround situations. Corporate culture is shaped by the incentives — intentional or inadvertent — for staff to behave a certain way. Culture has little obvious connection to financial results but has much to do with operating effectiveness. The key is to influence employee behavior through proper incentives and to focus on activities that will most rapidly exploit competitive advantage and positively affect the turnaround plan. These activities, of course, will depend on the nature of a business problem or situation. If implemented properly, these modified behaviors will facilitate better decision making, which, in turn, will improve operating effectiveness and financial results.

Every unhealthy company struggles with counterproductive internal behaviors, even if these same behaviors once enabled its growth or success. Undesirable behaviors do not appear suddenly; they typically become entrenched in the corporate culture over the course of many years. When these behaviors exacerbate core business problems, the primary job of the turnaround specialist is to identify and rectify them. In our experience, these counterproductive behaviors commonly are exhibited by employees with whom the turnaround professional is working on a day-to-day basis. These employees often understand and acknowledge that such behaviors are negatively impacting operations but lack the influence to effect change. Such employees frequently will open up to the turnaround team, offering their own diagnoses and, in some instances, proposing solutions.

In addition, we generally observe that companies that exhibit negative cultural behaviors tend to rely on long-tenured team members with significant institutional knowledge that is viewed as irreplaceable. The turnaround professional all too often hears "… well, that's how we've always done it …" in response to basic questions and inquiries of ineffective or broken processes. An immediate priority for the turnaround specialist is to understand and evaluate the current set of incentives motivating and rewarding existing behaviors, as well as their impact on performance.

The next step can cause a turnaround specialist to become extremely unpopular within a client's organization, as it is during this period that radical changes ordinarily are made and sacrifices are required. The turnaround specialist must create, with the assistance of management, and implement new standards and incentives to modify workplace behavior — a daunting exercise under any circumstances. A high priority is to address a negative cash flow problem through quick measures, which are wholly dependent on the situation and problems facing the organization, and may include the following:

- Centralizing operations to maximize cost efficiencies
- Decentralizing operations to promote revenue growth
- Closing certain business segments that are deemed to be irreparable
- Securing new contract terms with customers and vendors
- Introducing new metrics for staff productivity and performance

There's No Easy Path *continues on p. 12*

There's No Easy Path *continued from p. 11*

Because the changes in incentives and culture are sought to modify embedded behaviors by employees, there likely will be a fair degree of fallout. Embrace these reactions and do not become discouraged by any backlash. Voluntary employee separations are a signal that the message and goals are clear. Headcount reduction usually is inevitable during a restructuring process, and the least disruptive way is via natural attrition. As behavioral standards and expectations change, certain staff members will come to realize that they cannot thrive in the new environment.

Communication

Consistent communication is critical throughout the turnaround. Management must make sure all decisions — even the unpopular ones — are not only designed to accommodate the company's competitive advantages but also are communicated throughout the organization. All communications must be thorough, timely and consistent in nature. A world-class communication infrastructure is essential. The senior management team should be accessible even if the executives don't yet possess all the answers. When an answer is not immediately available, it must be obtained and then communicated in a timely manner. Employees don't necessarily have to agree with management's decisions, but the workforce does need to understand them. During turnaround situations (or other times of profound change), an information void can be extremely damaging. This is why management must be prompt in disclosing good and bad news alike.

A recent case that highlights some of the dynamics described above is a land developer and homebuilder that was faced with a crushing debt load and dwindling cash flows as a result of the residential real estate market collapse, subsequently filing for bankruptcy protection. The reorganization plan that was confirmed contemplated an exchange of pre-petition secured debt for substantially all the equity in the reorganized business. Although debt reduction was critical to the plan, it hardly was the end of the story. During the plan development process, key stakeholders generally agreed that the enterprise possessed a competitive advantage that no other firm in that market had: The business owned and controlled large tracts of highly desirable and valuable land, from raw land to fully developed planned communities. Prior to and after emergence from bankruptcy, the company took actions that were consistent with this competitive advantage. Several other aspects of the business operation changed as well, all of which supported the turnaround effort: i) the importance of communication was elevated, ii) corporate policies and incentives were modified to maintain consistency with the new goals and objectives and iii) other aspects of the corporate culture were addressed to ensure alignment with the turnaround strategy.

As a result of the actions taken and the difficult decisions made after the recapitalization was complete, the turnaround of the company can be described as successful. As of December 2011, the company had repaid a substantial amount of its post-emergence debt, restarted construction of residential homes in several communities, hired employees to accommodate this ramp-up and began discussions to refinance its debt.

Pitfalls

Most faltering companies have a fundamental problem in their core business, which is why the only way to execute a successful operational turnaround is to concentrate on these core activities. However, the first instinct of many managers when commencing a turnaround strategy is to slash costs. While cost cutting can help achieve a cash-neutral or cash-positive position in the short term, it will not solve underlying structural problems facing the business. Costs must be scrutinized at the appropriate time. From a long-term perspective, a company rarely cuts its way back to prosperity.

Another bad instinct is for managers to attempt to supplement a struggling core business by launching new products or entering untested markets. The rationale often espoused by management is that cash flows from latest business addition will help fund a turnaround of the core business. This is illogical, as such initiatives frequently require the use of precious capital and may distract senior management from the real task at hand. Instead, managers must capitalize on the company's core business and distinct competitive advantage. It is a focus on and exploitation of competitive advantage that will better serve to strengthen operating results and turn around the business over time.

Conclusion

When is a turnaround complete? There's no magic formula for deciding exactly when a company is firmly on a path to long-term growth and operational sustainability, but, in our experience, the board and management team will recognize when this corner is turned. The results of improved performance will be evident in the office and in the financial results. Staff turnover will have subsided. New behaviors will have been institutionalized. Successful turnarounds have many diverse elements: Financial engineering commonly is prescribed as a sufficient remedy, but we have found that even a recapitalized company ultimately will fail if its core business plan remains flawed and its internal culture and behaviors continue to support that flawed model. Turning around any large enterprise is a difficult, disruptive and oftentimes unpleasant undertaking. However, through the application of a rigorous strategic assessment, forthright and timely communication, endeavors to change the corporate culture and the application of consistent decision making, even a failing company realistically can aspire to recovery and, eventually, sustainable prosperity. ■

Gina Gutzeit, CIRA, CPA, CFE, *is a Senior Managing Director in FTI Consulting's New York office. She has over 25 years of experience in operational and financial restructuring, interim management, bankruptcy proceedings, process improvement and litigation services. Gina also serves on the Boards of Directors of AIRA and Richmond University Medical Center.*
Scott Rinaldi *is a Managing Director in FTI's Corporate Finance/ Restructuring practice in New York. He has more than 15 years of experience including engagements in the real estate, airline, retail, technology, funeral services, not-for-profit, telecommunications and manufacturing (paper products, print and industrial equipment) industries.*

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Tax Aspects of the Tribune Company Reorganization

Forrest Lewis, CPA

On July 23, 2012, U.S. Bankruptcy Judge Kevin Carey confirmed the Fourth Amended Plan of Reorganization probably ending the three and a half year odyssey of the (Chicago) Tribune Company chapter 11 bankruptcy case. All large bankruptcies present peculiar tax aspects, but this one had more than its share. The intent of this article is to analyze some of those tax aspects after giving an overview of the events preceding the bankruptcy and during the case. *In re: Tribune Company et al.,* US Bankruptcy Ct.-DE, 08-13141.

Events Leading Up to the Bankruptcy

The Chicago Tribune newspaper was founded in 1847 and continued in private hands until 1983. It had acquired a radio station in 1924 (renaming it WGN for "world's greatest news") and had acquired the Chicago Cubs baseball team from the Wrigley family in 1981. After going public in 1983, the Tribune Company engaged in an extensive program of acquisition of newspapers, television stations and even an online real estate internet service. As of 2007 the company held seven daily newspapers, including the Chicago Tribune, L.A. Times, Baltimore Sun and Newsday, as well as 23 television stations among many other investments.[1]

In 2007 investor Sam Zell took the Tribune Company back private through a leveraged buy-out in a series of complex transactions. As the reader will see, Zell and his team were extremely concerned about minimizing taxes. In "Step One" of the LBO, a newly formed Employee Stock Ownership Plan (ESOP) borrowed $4 billion and made a tender offer at $34 per share which acquired about 50 percent of the outstanding Tribune stock. The loan was guaranteed by all the subsidiaries of the company. In "Step Two" the ESOP formed an acquisition subsidiary and Tribune Company was merged into it. Then the ESOP borrowed another $4 billion and redeemed the remaining outstanding stock, leaving the ESOP as the sole shareholder. Mr. Zell had invested $315 million in a transitory position in Tribune stock and notes as part of Step Two and when the dust settled Zell emerged with warrants to acquire about 40 percent of the stock (which apparently were never exercised).[2]

One reason an ESOP was selected as an acquisition vehicle is that it is a tax exempt organization and an eligible shareholder of an S corporation which greatly reduces the chance of paying income tax. In 2008, Tribune Company elected S corporation status meaning that its annual taxable income will flow through to the shareholders. S corporations are subject to two forms of federal income taxation; first, regular annual taxable income is passed through to the shareholders, in this case a tax exempt entity which will end up paying no tax on the income. The second form of federal income taxation is the so called "built in gains tax" of Internal Revenue Code Section 1374 which applies at the corporate level, i.e. the Tribune Company level. Since the Tribune had historically been a C corp and the C corp tax regime is essentially a double tax regime, the S corporation will be exposed to the corporate level tax for 10 years on the gain from the sale of any asset it held on the date of the S election to the extent of the appreciation existing in the asset on that election date. Even though the ESOP is a tax exempt shareholder, that does not protect the Tribune Company S corp from incurring the built in gains tax (at rates up to 35 percent), it just defeats the double (or shareholder level) tax. The company also elected to treat its more than 100 subsidiaries as Qualified S corporation Subsidiaries, meaning that for tax purposes they were disregarded entities.[3] An S corporation owning all its subsidiaries as disregarded entities achieves single company tax treatment even more perfectly than a consolidated corporate group. More on the S election later as it probably will come back around to bite them.

Sale of Newsday

Only a few months after Mr. Zell took over Tribune Company, he moved to sell its Long Island-based newspaper, Newsday, for $580 million. Because of concern for the "built in gains tax," a technique called the "leveraged partnership strategy" is thought to have been used to defer the built in gains tax at the S corporation level. Essentially, a leveraged partnership works this way: the Tribune Company drops the assets of Newsday into a newly formed partnership and the "buyer," News Corp, drops in a substantial cash injection, say $100 million for a 95 percent interest in the partnership. The partnership then borrows $580 million from a third party lender which Tribune Company, now a 5 percent owner, guarantees. Then, $580 million is subsequently distributed to Tribune Company. The Tribune's guarantee of the loan gives it tax basis so that the cash distribution will not be taxable and is thought to protect it from attack as a "disguised sale" per Reg. 1.707-5(b)(1). While the receipt of the cash is not immediately taxable to Tribune Company, it creates a negative partnership tax capital account for Tribune. At some point down the road when Tribune terminates its participation, the negative tax capital account creates taxable income. In this case there were calls and puts after 10 years to take out the 5 percent partner. Thus, probably no tax was immediately paid on the Newsday sale, neither at the Tribune Company level nor the ESOP level.[4] In the peculiar facts of the Tribune case, it might have been possible to permanently escape taxation since the built in gains tax only applies for the first 10 years of the S corp election. Unfortunately for Tribune, circumstances overtook them long before that.

Filing of Chapter 11 Petition

The timing of the 2007 LBO transaction was very unfortunate as the financial meltdown of 2008 exacerbated already downward spiraling revenues in print and television media partly due to the expansion of the internet. Tribune Company and most of its 100-plus subsidiaries filed petitions in bankruptcy on December 8, 2008, barely a year after the LBO. Many factors led to a long and acrimonious case before the Plan of Reorganization was finally

1 Disclosure Statement p. 16 et seq., (references are to page numbers in the underlying document, not the .pdf page number) Docket #4008, all docket numbers are found at: http://dm.epiq11.com/TRB/Project

2 Disclosure Statement p. 28, 56

3 Disclosure Statement, p. 136.

4 CFO.com, Willens article, April 28, 2008.

approved in 2012: the complexity of the debtors' businesses, the many contending creditors, the guarantees by the subsidiaries and questions over the fundamental legitimacy of the 2007 LBO transaction. The bona fides of Step Two of the transaction, particularly the valuations used, were highly criticized in an Examiner's Report requested by the bankruptcy court.[5]

Sale of the Chicago Cubs

In 2006, Tribune Company had begun negotiations to sell the ownership of the Chicago Cubs baseball team but many false starts and delays were incurred during the next two years, no doubt partly due to the complications of finding a bidder willing to take part in a "leveraged partnership strategy." Though some initial offers were made in excess of $1 billion, due to the backsliding economy, in 2009 the Ricketts family ended up acquiring a 95 percent interest in the team for $845 million which was still a record sales price at that time.[6] Since the team had been originally purchased in 1981, there was undoubtedly a large gain but again the "leveraged partnership strategy" was thought to have been used to avoid any immediate tax on the sale resulting in a $740 million cash distribution to Tribune Company which was in the Chapter 11 proceeding by this time.[7] (There was an interesting report that the acquiring partnership was allowed to amortize the amount of the purchase price allocated to the league franchise for tax purposes over 15 years as a result of changes to IRC Section 197 enacted in 2004 despite the fact the franchise never expires, but on the other hand the amount allocated to player contracts as an asset also has to be amortized over 15 years according to Section 197(d)(1)(C)(1) notwithstanding that their terms are generally much shorter than 15 years.)

Confirmed Plan of Reorganization

The official liquidation analysis indicated a net recovery on a distress sale basis of only $3.4 billion on $13.4 of claims after payment of administrative expenses and priority claims.[8] This no doubt played into the decision of the major creditors to reorganize and emerge. The Plan provides primarily for a recapitalization and emergence of Tribune Company. Prior equity will be completely extinguished[9] and senior debt will receive a combination of New Common Stock, New Debt and some cash.[10] Three parties will own the majority of the emerging entity—JP Morgan Chase & Co., Oaktree Capital LLC and Angelo Gordon & Co.[11] As in most bankruptcies where there is not enough to go around, some classes will get some recovery and some classes will get none. Some of the junior creditors, who only expect to recover 18 cents on the dollar, filed an immediate appeal of the confirmation after the Plan was confirmed.[12] Another significant point is that the Plan is intended to resolve all claims and litigation from the considerable number of adversary proceedings over the 2007 LBO. (Despite this, there is an action in the federal district court in New York to claw back the amount paid to the public for the stock in the 2007 LBO.)[13]

Tax Treatment of Confirmed Plan

The distribution of New Common Stock and New Debt is intended to qualify for income tax purposes as an IRC Section 368 Type E nontaxable recapitalization. Recipients will not be taxable on the stock and debt received. To the extent that the fair market value of the stock, debt and cash are less than the amount of the related lenders' claims, the difference will constitute cancellation of debt income to the debtor. Because Tribune Company is in bankruptcy, the COD income will not be subject to federal income tax. Generally the price to pay for nontaxable COD income is reduction of net operating loss carryforwards which are almost a constant in corporate bankruptcies, but because any net operating losses incurred in this case before the effective date passed through to the ESOP where they were effectively lost by (i.e. wasted on) the tax exempt organization, there are no net operating loss carryforwards to reduce.

The Plan says that after the distribution of the New Common Stock, the S corp election of Tribune Company will be terminated, presumably because it will have ineligible partnership and corporate shareholders.[14] It will then default to a regular, taxable C corporation. This is where the S election hurts the future tax situation of Tribune Company. Under some favorable rules for debtors in bankruptcy in Internal Revenue Code Section 382(l), most bankrupt entities manage to make some use of their net operating losses to offset taxable income from sale of subsidiaries and other assets. In this case, Tribune Company will start the new era with none.

Since it is expected that the emerging debtor will embark on an aggressive program of selling businesses and assets, it will benefit from one favorable limitation in the tax rules. One of the favorable tax attributes that must be reduced in consideration of nontaxable COD income is asset basis. However, there is a limitation in Internal Revenue Code Section 1017(b), which says that asset basis may not be reduced below the amount of liabilities remaining after the discharge. According to the Disclosure Statement, the amount of remaining liabilities will be such that no reduction in asset basis will be made.[15] Thus, as it goes forward selling assets, Tribune Company will at least have its original purchase basis in the assets sold intact to reduce taxable gains.

Another part of the Plan is the merger of many of Tribune Company's former corporate subsidiaries and their conversion to limited liability companies.[16] Presumably this is to preserve their "disregarded entity tax status" since a single member limited liability company is a disregarded tax entity similar to the Qualified S corporation Subsidiary status they were in since 2008. Thus, they will continue to achieve single entity tax treatment. The timing of the conversions, which can be a little tricky, is not discussed in the Disclosure Statement. When a S corp terminates, all its Qualified S corporation Subsidiaries become

Tribune Company Reog. *continues on p. 16*

5 Examiner's Report, Vol. 1, p. 8 et seq., (found under "Key Documents" at Epiq website).
6 ESPN.com article August 23, 2009.
7 AICPA Store website, Thomas Wechter article, December 9, 2009.
8 Exhibit E, Liquidation Analysis p. 6, Docket #4008.
9 Disclosure Statement, p.71.
10 Exhibit B, Term sheet p. 2, Docket #4008.
11 Crain's Chicago Business, July 22, 2012.
12 Reuters.com, July 24, 2012.
13 L.A. Times, July 23, 2012.
14 Disclosure Statement, p. 136.
15 Disclosure Statement, p. 137.
16 Exhibit H, restructuring charts, Exhibit 5.2, Docket #12072.

Tribune Company Reog. *continued from p. 16*

C corporations. The conversion of a solvent C corporation subsidiary to a single member LLC is generally a nontaxable IRC Section 332 liquidation but the conversion of an insolvent C corporation can be a taxable liquidation. Therefore, it is generally undesirable to have the entities revert to a C corp first and then convert to a single member LLC. The Plan contains very broad language authorizing all needed restructuring transactions: mergers, liquidations, conversions, etc.[17] and perhaps they are relying on the powers of the bankruptcy court to effect business entity legal changes without first observing all the formalities of state law to accomplish the conversion on the effective date.

Conclusion

It has been a long and strange journey for Tribune Company. The controversial leveraged buy-out facilitated the S election by Tribune Company creating great tax efficiency by virtue of the ESOP. While the company managed to defer taxation in the sale of Newsday and the Cubs, the S election resulted in an emerging C corporation with intentions of selling many assets but no net operating loss carryforwards to reduce the tax bill. In 2010 the IRS successfully attacked a leveraged partnership arrangement with weaker facts but the leveraged partnership technique can still be valid according to a recent statement from one IRS official.[18] However, the reorganized Tribune Company may no longer wish to entertain the complications of the long tax "tail" inherent in executing more leveraged partnership transactions. ■

Thanks to Louis Freeman, Esq., for his insights, and Grant Newton and Dennis Bean for their assistance with this article.

17 Confirmed Plan of Reorganization, Docket #11747, p.50-51.

18 BNA Daily Tax Reports, May 24, 2012.

Bankruptcy Taxes

Forrest Lewis, CPA

RECENT COURT TAX CASES

Supreme Court Settles Farm Bankruptcy Tax Liability Issue in Favor of IRS

The Supreme Court has put to rest the controversy about who has to pay the income tax when farm assets are sold under a Chapter 12 reorganization plan. The Court ruled the federal income tax liability resulting from petitioners' post-petition farm sale is not "incurred by the estate" under §503(b) of the Bankruptcy Code and thus is neither collectible nor dischargeable in the Chapter 12 plan. The individual petitioners were held liable for the tax. Some courts had held that income tax debt arising from sale of the farm assets under the Plan were not a liability of the estate but became unsecured claims which were dischargeable under the Plan. Thus, in some cases, little or no tax was paid on sales incident to the Plan. However, the Supreme Court upheld the IRS which has argued all along that the individual debtors were personally liable for the tax. *Hall v. United States*, U.S., No. 10-875, 5/14/12.

Third Circuit Rules Sales Taxes Are Nondischargeable Trust Fund Taxes

The Third Federal Circuit consistent with precedent recently ruled that unpaid New Jersey state sales taxes are a "trust fund tax" which are always prioritized and are never dischargeable irrespective of the age of the debt, similar to withheld payroll taxes. §§507(a)(8)(C), 523(a)(1)(A). The debtor had argued that the taxes were "excise taxes" which are also priority taxes but can be discharged after three years. Apparently this is a national rule based on the history of federal bankruptcy legislation despite the fact some states like New Jersey impose the tax on the customer while others impose the tax on the retailer but allow the retailer to pass the tax along to the customer. A tax imposed on the retailer is more similar to an excise tax, but that does not appear to matter. Unpaid sales taxes and payroll taxes are very common in bankruptcy cases and should command substantial attention from bankruptcy trustees and their advisers. *In Re: Michael Calabrese, Jr.*, No. 11-3793 (D.C. No. 10-cv-06583) July 20, 2012.

Bankruptcy Panel Affirms Tax Credits Must Be Considered In Valuing Apartment Buildings

A Bankruptcy Appellate Panel in the Sixth Circuit recently held that low income housing credits under IRC Section 42 which ran with the apartment buildings in the five limited partnerships at issue must be considered in valuing the property. Each apartment complex was developed in conjunction with federal low-income housing tax credit programs pursuant to Internal Revenue Code Section 42. The debtors filed for bankruptcy in September and October 2010. The debtors and their general partners sought to determine the value of the Bank of America's secured claims in the realty pursuant to the Bankruptcy Code by excluding the value of any remaining tax credits. Bank of America objected. The BAP held that the credits are "covenants running with the real properties. This was true even though the debtors allocated the credits to individual partners. A determination of the debtors' interest in the properties must include consideration of the value of the credit because a willing buyer would most certainly consider the availability of the Section 42 tax credits when determining the fair cash value of the property." (*In re Creekside Senior Apartments LP*, B.A.P. 6th Cir., No. 11-8072, 6/29/12).

RECENT IRS RULINGS

Favorable Ruling on Partnership Nonrecourse Debt Insolvency

In a recent ruling, the Internal Revenue Service made two holdings favorable to partners in troubled real estate partnerships with nonrecourse debt, a common fact pattern in real estate. Here is a simplified version of the example posed in the ruling:

X, an individual investor, and Holdco, a corporation, are equal partners in PRS, a partnership for federal tax purposes. In Year 1, PRS borrows $1,000,000 from Bank and signs a note payable to Bank for $1,000,000 that bears interest at a fixed market rate payable annually. The note is secured by real estate valued in excess of $1,000,000. The note is a nonrecourse liability within the meaning of §1.752-1(a)(2) of the Income Tax Regulations,

meaning that in the case of any deficiency, neither PRS nor its partners (X and Holdco) are personally liable on the note.

In Year 2, when the value of the real estate is $800,000 and the outstanding principal on the note is $1,000,000, Bank agrees to modify the terms of the note by reducing the note's principal amount to $825,000. The modified note bears adequate stated interest for tax purposes. The PRS partnership agreement provides for income to be allocated equally to X and Holdco under §704(b) and the regulations thereunder. X and Holdco share PRS nonrecourse liabilities equally under §1.752-3. The specific exclusion provided by §108(a)(1)(A) (bankruptcy exception) does not apply in this case.

IRS holdings: First, the $175,000 of cancellation of debt income is allocated according to the normal allocation of income under the partnership agreement, in this case 50/50. Then, under the rules for COD recognition in partnerships, eligibility for the various favorable tax treatments of COD income under Internal Revenue Code Section 108 are tested at the partner level, not the partnership level. For example, if the partner is insolvent or in federal bankruptcy, the COD income will not be subject to income taxation. According to the ruling, the pass-through of the COD income will be treated as additional liabilities at the partner level. Thus in this example, X and Holdco each are treated as incurring $87,500 of liabilities which they will include in the calculation of their insolvency test. (Note: the ruling specifically provides that the partnership in the example is *not* in a situation called "minimum gain recognition." However, minimum gain recognition is fairly common in loss real estate partnerships and in that case, taxable income is recognized and usually unavoidable.) [Rev. Rul. 2012-14]

IRS Clarifies When Student Loans and State Tax Obligations May Be Considered in Collection Guidelines

Some Internal Revenue Service Collections Officers have long considered student loan obligations and state and local tax debts in determining eligibility for federal offers in compromise and installment agreements but the National Office has recently clarified the guidelines.

The new guidelines state:

"When analyzing income and expenses to determine a taxpayer's ability to pay, minimum payments on student loans guaranteed by the federal government will be allowed for the taxpayer's post-high school education. Taxpayers must verify that the loan is guaranteed and substantiate that the payments are being made. Taxpayers with student loan debt, who have not yet made arrangements to repay the loan, should be allowed 10 days to set up a payment plan for the student loan and provide verification so the loan payment can be allowed. Additional time may be allowed if a taxpayer has extenuating circumstances. Taxpayers must be advised that if they do not respond by the due date, the installment agreement amount will be established without allowing for a student loan payment. Taxpayers must also be advised that if they later make arrangements to pay the student loan, they can request the installment agreement be revised.

Taxpayers who have student loan debt, but are unable to make payments on the debt because they are suffering an economic hardship or have medical problems, should be advised to request a deferment or forbearance of the student loan payments. The installment agreement amount will be established without allowing for a student loan payment. Taxpayers must be advised that if they later make arrangements to pay the student loan, they can request the installment agreement be revised.

When a taxpayer owes both delinquent federal taxes and state or local taxes, and does not have the ability to full pay the liabilities, monthly payments to state or local taxing authorities may be allowed in certain circumstances…" The memorandum contains a chart calculating the allowable amount of state and local taxes to consider based on the relative amounts of the federal and state taxes, which was assessed first, etc.

[SBSE-05-0512-047] The article may be found on the IRS website at: http://www.irs.gov/pub/foia/ig/sbse/sbse_05-0512-047.pdf

Capitalized Debt Issuance Costs Are Not Part of COD

In a private letter ruling involving a corporation in a Chapter 11 proceeding, the debtor corporation had capitalized certain debt issuance costs, presumably legal, appraisal or financing fees necessary to obtain the loan, which is a common fact pattern. The tax law requires such costs to be capitalized but they can be deducted ratably over the life of the loan. When a loan is terminated before its full term, a deduction for the remaining balance of the costs is generally allowed. But is that same amount considered cancellation of debt income? COD income outside of bankruptcy can be taxable and even in bankruptcy, it can result in the reduction of certain favorable tax attribute carryforwards such as net operating losses. However, the IRS ruled that debt issuance costs are really not part of the debt and no COD is created by the debt issuance costs when the underlying loan is discharged. [PLR 201220004]

IRS PROPOSES TO LIBERALIZE S CORP DEBT RULES

The Internal Revenue Service recently proposed a taxpayer favorable clarification of the rules treating loans by a S corp shareholder to the corporation as tax basis which permits the pass through of losses to the shareholder. In the last 30 years the IRS had won a number of cases taking a very conservative stance known as the "economic outlay" test, though it never followed through to try to promulgate that rule in regulations. However, because taxpayers continue to win some cases under a less stringent standard, the IRS decided to compromise in the recently proposed amendments to Reg. 1.1366-2 by establishing the "bona fide debt" test. [REG-134042-07].

The contrast can be most clearly seen in what are called "back to back" loans. In a very common fact pattern, an S corp shareholder might cause a related entity which he owned, say a C corporation which happened to have cash, to make a loan to the individual and then he would loan the funds to the S corp. Under the "economic outlay" test, the IRS disallowed such a loan as an addition to tax basis because of the circular flow of funds and no "new money" came into the equation, thus there was no "economic outlay" by

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Bankruptcy Taxes *continued from p. 17*

the shareholder. Under the "bona fide debt" test of the proposed regulations, presumably if the loan is properly documented with checks, a written note, security when appropriate, a market rate of interest, etc., the loan will be recognized as giving tax basis to the individual in the S corp.

Another common but controversial fact pattern involves a case where a third party makes a loan to the S corp but that loan is later assumed (not just guaranteed) by the individual shareholder. The proposed regulation contains this example:

> *Example 4. Loan restructuring through distributions*. A is the sole shareholder of two S corporations, S1 and S2. In March 2013, S1 made a loan to S2. In December 2013, S1 assigned its creditor position in the note to A by making a distribution to A of the note. Under local law, after S1 distributed the note to A, S2 was relieved of its liability to S1 and was directly liable to A. Whether S2 is indebted to A rather than S1 is determined under general Federal tax principles and depends upon all of the facts and circumstances. ……..If the note constitutes bona fide indebtedness from S2 to A, the note increases A's basis of indebtedness in S2……"

The regulation contains another taxpayer favorable position by stating that a loan to a S corp made by a tax disregarded entity, such as a single member LLC owned by an individual, will be attributed to the entity's owner, in other words the individual will be treated as making the loan directly. However, the proposed reg is careful to state that mere guarantee of third party debt cannot give rise to tax basis in the S corp context as it does in the partnership context.

Though the proposed regulation is just in the comment stage, Reg. 1.6662-4(d)(3)(iii) says that reliance on a proposed regulation does constitute "substantial authority" for abatement of the substantial understatement penalty. ■

Forrest Lewis, CPA, *Section Editor, is a tax practitioner based in East Lansing, Michigan. Thanks to Grant Newton and Dennis Bean for their assistance with this article.*

Bankruptcy Cases

Professor Baxter Dunaway

SUPREME COURT OF THE UNITED STATES

RadLAX Decision: Creditors' Right to Credit Bid

Must a Chapter 11 plan proposing to sell a creditor's collateral free and clear of liens also provide the creditor a right to credit bid?

The Supreme Court held that a Chapter 11 plan proposing to sell a creditor's collateral free and clear of liens must also provide the creditor a right to credit bid . *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 132 S.Ct. 2065, 80 USLW 4399, 12 Cal. Daily Op. Serv. 5784, 2012 Daily Journal D.A.R. 6974, 23 Fla. L. Weekly Fed. S 328 (U.S. May 29, 2012) (NO. 11-166).

Background

Chapter 11 debtors sought to "cram down" plan that provided for sale of assets securing bank's claim free and clear of all liens, and moved for approval of bid procedures that would not allow bank to credit bid amount of its claim. The United States Bankruptcy Court for the Northern District of Illinois, Bruce W. Black, J., 2010 WL 6634603, denied this bid procedures motion, and debtors appealed. The United States Court of Appeals for the Seventh Circuit, Richard D. Cudahy, Circuit Judge, 651 F.3d 642, affirmed. Certiorari was granted.

Holding

The Supreme Court, Justice Scalia, held that "cramdown" plan which contemplated sale of encumbered assets of Chapter 11 debtors free and clear of all liens had to satisfy requirements set forth in statutory clause specifically dealing with the "cramdown" of such "sales" plans, and could not be confirmed on "indubitable equivalence" theory. *Affirmed.*

Syllabus: To finance the purchase of a commercial property and associated renovation and construction costs, petitioners (debtors) obtained a secured loan from an investment fund, for which respondent (Bank) serves as trustee. The debtors ultimately became insolvent, and sought relief under Chapter 11 of the Bankruptcy Code. Pursuant to 11 U.S.C. § 1129(b)(2)(A), the debtors sought to confirm a "cramdown" bankruptcy plan over the Bank's objection. That plan proposed selling substantially all of the debtors' property at an auction, and using the sale proceeds to repay the Bank. Under the debtors' proposed auction procedures, the Bank would not be permitted to bid for the property using the debt it is owed to offset the purchase price, a practice known as "credit-bidding." The Bankruptcy Court denied the debtors' request, concluding that the auction procedures did not comply with § 1129(b)(2)(A)'s requirements for cramdown plans. The Seventh Circuit affirmed, holding that § 1129(b)(2)(A) does not permit debtors to sell an encumbered asset free and clear of a lien without permitting the lienholder to credit-bid.

Held: The debtors may not obtain confirmation of a Chapter 11 cramdown plan that provides for the sale of collateral free and clear of the Bank's lien, but does not permit the Bank to credit-bid at the sale. Pp. 2069 – 2073. (a) A Chapter 11 plan proposed over the objection of a "class of secured claims" must meet one of three requirements in order to be deemed "fair and equitable," and therefore confirmable. The secured creditor may retain its lien on the property and receive deferred cash payments, § 1129(b)(2)(A)(i); the debtors may sell the property free

and clear of the lien, "subject to section 363(k)"—which permits the creditor to credit-bid at the sale—and provide the creditor with a lien on the sale proceeds, § 1129(b)(2)(A)(ii); or the plan may provide the secured creditor with the "indubitable equivalent" of its claim, § 1129(b)(2)(A)(iii).

Here, the debtors proposed to sell their property free and clear of the Bank's liens and repay the Bank with the sale proceeds, as contemplated by clause (ii). Because the debtors' auction procedures do not permit the Bank to credit-bid, however, the proposed sale cannot satisfy the requirements of clause (ii). The debtors claim their plan can instead satisfy clause (iii) by providing the Bank with the "indubitable equivalent" of its secured claim, in the form of cash generated by the auction. *** 2 0 6 8** The debtors' reading of § 1129(b)(2)(A), under which clause (iii) permits precisely what clause (ii) proscribes, is hyperliteral and contrary to common sense. "[I]t is a commonplace of statutory construction that the specific governs the general." *Morales v. Trans World Airlines, Inc.,* 504 U.S. 374, 384, 112 S.Ct. 2031, 119 L.Ed.2d 157. Here, where general and specific authorizations exist side-by-side, the general/specific canon avoids rendering superfluous a specific provision that is swallowed by the general one. See *D. Ginsberg & Sons, Inc. v. Popkin,* 285 U.S. 204, 208, 52 S.Ct. 322, 76 L.Ed. 704. As applied to § 1129(b)(2)(A), the canon provides that the "general language" of clause (iii), "although broad enough to include it, will not be held to apply to a matter specifically dealt with" in clause (ii). 285 U.S., at 208, 52 S.Ct. 322. Although the canon can be overcome by other textual indications of statutory meaning, the debtors point to none here. Pp. 2069 – 2072.
(b) None of the debtors' objections to this approach is valid. Pp. 2072 – 2073. 651 F.3d 642, *affirmed*.

SCALIA, J., delivered the opinion of the Court, in which all other Members joined, except KENNEDY, J., who took no part in the decision of the case.

Bankruptcy Capital Gains Tax From Chapter 12 Sale

The U.S. Supreme Court ruled that farmers who sold farm assets during a bankruptcy reorganization under chapter 12 of the Bankruptcy Code were liable for the full amount of the capital gains tax that resulted from the sale. [See article by Prof. Jack F. Williams in *AIRA Journal* Vol. 25:6, *Hall v. United States:* What a chapter 12 tax case can teach us about the Supreme Court and the Bankruptcy Code – Part 1].

Hall v. U.S., 132 S.Ct. 1882, 80 USLW 4357, 109 A.F.T.R.2d 2012-2020, 2012-1 USTC P 50,345, 56 Bankr.Ct.Dec. 122, Bankr. L. Rep. P 82,212, 12 Cal. Daily Op. Serv. 5189, 2012 Daily Journal D.A.R. 6225, 23 Fla. L. Weekly Fed. S 293 (U.S. May 14, 2012) (NO. 10-875)

TENTH CIRCUIT COURT OF APPEALS

Requirement to Possess a Bearer Instrument

Can Colorado creditor (Deutsche Bank) in mortgagor's (Miller's) bankruptcy initiate public trustee foreclosure without producing original promissory note?

The Tenth Circuit Court of Appeals holds that a Colorado creditor could not initiate public trustee foreclosure of mortgage without producing original promissory note. The key question is: Without possession of the note, is Deutsche Bank a "creditor" of Miller's with standing to seek relief from the automatic stay in order to foreclose? *In re Miller*, 666 F.3d 1255, Bankr. L. Rep. P 82,169 (10th Cir. Feb 01, 2012) (NO. 11-1232).

Facts

Bankruptcy court issued order relieving Colorado creditor Deutsche from automatic stay to permit foreclosure on Colorado Chapter 13 debtors Miller's house to continue foreclosure. Debtors appealed. The United States Bankruptcy Appellate Panel, 2011 WL 1807015, *affirmed*. Debtors appealed.

Holdings

The Court of Appeals held that:(1) *Rooker–Feldman* doctrine did not apply; (2) issue preclusion did not apply; (3) creditor did not show that it was current holder of promissory note; and (4) creditor could not initiate Colorado public trustee foreclosure sale without producing original promissory note. Reversed and remanded. *In re Miller*, 666 F.3d 1255, Bankr. L. Rep. P 82,169 (10th Cir. Feb 01, 2012) (NO. 11-1232).

The key question: Is Deutsche Bank a Colorado "creditor" of the Miller's bankruptcy with standing to seek relief from bankruptcy stay? The Court applied Colorado law, in particular that state's version of the Uniform Commercial Code ("U.C.C." or "Code") and held that the Court creditor could not initiate Colorado public trustee foreclosure sale without producing original promissory note.

To answer this question, the Court turned to the Bankruptcy Code. According to the Bankruptcy Code, a "creditor" includes an "entity that has a claim against the debtor." 11 U.S.C. § 101(10)(A). A "claim" is a "right to payment." *Id.* § 101(5)(A).

Does Deutsche Bank have a "right to payment" from the Millers? In examining this question, the Court began with the principle that "[w]ithin the context of a bankruptcy proceeding, state law governs the determination of property rights." *In re Mims,* 438 B.R. 52, 56 (Bankr.S.D.N.Y.2010). .The Court therefore applied Colorado law, in particular that state's version of the Uniform Commercial Code (U.C.C. or Code).

The Court asked how Colorado law would classify the Note signed by the Millers. Under Colorado law, a promise or order such as the Note is payable "to order" "if it is payable (i) to the order of an identified person or (ii) to an identified person or order." Colo.Rev. Stat. § 4–3–109(b). The Note at issue here is payable "to the order of Lender"—Lender is IndyMac Bank. Thus, the Note is payable to the "order" of IndyMac Bank under § 4–3–109(b). But "[a]n instrument payable to an identified person [such as IndyMac Bank] may become payable to bearer if it is indorsed in blank pursuant to section 4–3–205(b)." Colo.Rev.Stat. § 4–3–109(c) Section 4–3–205(b) provides that "[i]f an indorsement is made by the holder of an instrument and it is not a special indorsement, it is a 'blank indorsement.' When indorsed in blank, an instrument becomes payable to bearer and may be *negotiated by transfer of possession* alone until specifically indorsed." (emphasis added).

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Deutsche Bank presented evidence that IndyMac had indorsed the Note in blank. Is proof of this indorsement sufficient under the U.C.C. requirements to establish Deutsche Bank as the successor holder of the note? As the Court noted, it is not, because Deutsche Bank must also prove it has possession of the Note.

The U.C.C. identifies the requirements for "negotiation" of a note, that is, for "transfer of possession ... to a person who thereby becomes its holder." *Id.* § 4–3–201(a). This statute provides that "if an instrument is payable to an identified person, negotiation requires *transfer of possession* of the instrument and its indorsement by the holder." *Id.* § 4–3–201(b) (emphasis added). The Official Commentary to section 4–3–201 explains that negotiation "*always requires a change in possession of the instrument* because nobody can be a holder without possessing the instrument, either directly or through an agent" (emphasis added). *See also* Colo.Rev.Stat. § 4–1–201(b)(20)(A) (defining "holder" of negotiable instrument as "person in possession" of it). "Possession is an element designed to prevent two or more claimants from qualifying as holders who could take free of the other party's claim of ownership." *Georg v. Metro Fixtures Contractors, Inc.,* 178 P.3d 1209, 1213 (Colo.2008) (citation omitted). "With rare exceptions, those claiming to be holders have physical ownership of the instrument in question." *Id.* (citation omitted). In the case of bearer paper such as the Note, physical possession is essential because it constitutes proof of ownership and a consequent right to payment.

The Court of Appeals concluded that the evidence is insufficient as it currently stands to establish that Deutsche Bank is a "party in interest" entitled to seek relief from stay. The bankruptcy court therefore abused its discretion by granting Deutsche Bank relief from stay.

Additional cases regarding requirement to possess a bearer instrument: Oklahoma law also provides that physical possession of a bearer instrument is essential to asserting a claim based on that document. *See* Okla. Stat. Ann. tit. 12A, §§ 3–201, 3–203, and 3–301 (1991). *See also Deutsche Bank Nat'l Trust v. Brumbaugh,* 270 P.3d 151, 153–54 (Okla.2012) (entitlement to enforce a note is essential to plaintiff's standing to seek foreclosure, and enforcement requires possession). The U.C.C. has been adopted in most jurisdictions, including both Colorado (Colo.Rev. Stat. § § 4–1–101 to 4–11–102) and Oklahoma (Okla. Stat. Ann. tit. 12A, §§ 1–101 to 11–107). *In re* Lippold, 457 B.R. 293 (Bankr. S.D.N.Y. 2011) (assignee of mortgage failed to demonstrate standing); *In re* Escobar, 457 B.R. 229 (Bankr. E.D.N.Y. 2011) (affidavit stating that servicing agent was holder of mortgage note based on possession of original note executed with endorsements in blank was sufficient to grant party in interest standing to seek relief from stay); *In re* Sterling Estates (Del.), LLC, 2011 Bankr. LEXIS 54 (Bankr. N.D. Ill. Jan. 6, 2011) (special servicer demonstrated requisite standing by introducing Pooling and Servicing Agreement); Standing *In re* Mims, 438 B.R. 52 (Bankr. S.D.N.Y. 2010) (assignee lacked standing to exercise any state law remedies; therefore, lacked standing to seek relief from stay); *In re* Hwang, 438 B.R. 661 (C.D. Cal. 2010) (reversing bankruptcy court and determining that holder of promissory note was real party in interest and had standing). Robert E. Ginsberg, Robert D. Martin and Susan V. Kelley§ 3.06 Procedure for Obtaining Relief from the Stay ((Cite as: GMBKR s 3.06). Neil B. Cohen, Mortgage Notes and Who Can Enforce Them, ST044 ALI-ABA 353 (April 26 - 27, 2012).

SECOND CIRCUIT COURT OF APPEALS

Vacating an Arbitration Award

What is the standard for vacating an arbitration award?

In the Second Circuit Court of Appeals, the Appellant Goldman Sachs argued that the arbitration award rendered against Goldman must be vacated because it was rendered in manifest disregard of the law. The Court rejected the Goldman arguments and affirmed the judgment of the district court. *Goldman Sachs Execution & Clearing, L.P. v. Official Unsecured Creditors' Committee of Bayou Group, LLC*, --- Fed.Appx. ----, 2012 WL 2548927 (2nd Cir. (N.Y.) Jul 03, 2012) (NO. 10-5049-CV, 11-2446-CV XAP).

Although the Supreme Court's decision in *Hall Street Associates, L.L.C. v. Mattel, Inc.,* 552 U.S. 576, 585, 128 S.Ct. 1396, 170 L.Ed.2d 254 (2008) created some uncertainty regarding the continued viability of the manifest disregard doctrine, the Second Circuit Court of Appeals concluded that "manifest disregard remains a valid ground for vacating arbitration awards." *T.Co Metals, LLC v. Dempsey Pipe & Supply, Inc.,* 592 F.3d 329, 339–40 (2d Cir.2010) (internal quotation marks omitted); *see also Schwartz v. Merrill Lynch & Co.,* 665 F.3d 444, 451–52 (2d Cir.2011); *STMicroelectronics, N.V. v. Credit Suisse Securities (USA) LLC,* 648 F.3d 68, 78 (2d Cir.2011). ■

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

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