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Control Premiums: Exploring the Complexities of a Seemingly Simple Concept

The resource libraries of valuation professionals are replete with text books and articles that reference techniques and empirical studies that provide guidance regarding the proper application and quantification of control premiums. Despite the war chest of authoritative literature, the valuation profession has not endorsed a specific technique or rule for applying a control premium that can be universally applied in all situations. The process is subject to the judgment of the appraiser and the circumstances surrounding the valuation exercise.

A control premium is intended to capture the additional price that investors will pay for a controlling interest (versus a minority interest) in a company. Control over a corporate entity entitles the shareholder to a bundle of rights that minority shareholders do not enjoy, such as the ability to:

1. Appoint or change operational management.
2. Appoint or change members of board of directors.
3. Determine management compensation and perquisites.
4. Negotiate and consummate mergers and acquisitions.
5. Liquidate, dissolve, sell out, or recapitalize the company.
6. Register the company's equity securities for an initial or secondary public offering.
7. Declare and pay cash and/or stock dividends.
8. Change the articles of incorporation or bylaws.
9. Block any or all of the above items.

The only compelling empirical data supporting the notion that investors will pay a premium for

control is derived from an analysis of corporate takeovers of publicly traded companies.

Mergerstat® / Shannon Pratt's Control Premium Study™ is a database of public company acquisitions that measures the trading price of the stock of the acquired company one day, one week, one month, and two months prior to the announcement date of a merger. It compares the prior stock prices to the implied stock price embedded in the takeover. Since 1998, approximately 85% of all public company takeovers closed at values that exceeded that market capitalization (stock price times shares outstanding) of the company in the period preceding the takeover. The premium paid each year in these transactions averaged between 29.0% and 53.9% from 1998 through 2006.

The magnitude and frequency of the control premiums paid in public company transactions warrant careful consideration of the control premium issue in the valuation of business enterprises, particularly in instances where public company stock prices are used as a basis to determine value. This article will explore the challenges and controversies regarding the use and application of control premiums. Valuation professionals' opinions differ on the need for control premiums and courts are divided on the applicability of control premiums in solvency and plan confirmation disputes.

II. Harmonize Valuation Approaches

Valuing a business enterprise will often involve the application of several valuation approaches. Among the most commonly used are the Transaction Multiple Approach, the Discounted Cash Flow ("DCF") Approach and the Guideline Company Approach. Each of these approaches can be used to derive the fair market value of a business enterprise for plan confirmation or solvency purposes. The data and assumptions used in the application of each approach will determine whether the resultant value is a control value (a value ascribed to the entire company) or a marketable minority value (a

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Baxter Dunaway - Section Editor
Jack Williams - Scholar in Residence
Forrest Lewis - Section Editor



Executive Director's Column

Grant Newton, CIRA
AIRA Executive Director

A new book by Shannon P. Pratt and Roger J. Grabowski, *Cost of Capital in Litigation: Applications and Examples*, expands on a prior section in their book *Cost of Capital: Applications and Examples*, third edition (fourth edition to be released soon) and further explores its role in the courts. *Cost of Capital in Litigation* will be released in November by John Wiley & Sons (hardcover, 336 pages, list price US \$95, ISBN: 978-0-470-88094-4). Grabowski is managing director with Duff & Phelps LLC and Pratt is Chairman and CEO of Shannon Pratt Valuations, Inc.

The first three chapters of the book focus on theories and concepts underlying the determination of the cost of capital. Chapter 1 examines the fundamentals of cost of capital. Chapter 2 alone is worth the cost of the book. This chapter describes in a style that is easy to follow the cost of equity capital and the overall cost of capital providing justification for each component of the equation. Valuation professionals that prefer to include lack of marketability as a component of the discount rate will find the treatment in chapter 3 extremely valuable. Also included in chapter 3 is a detailed discussion of discrete percentage discount for lack of marketability and how the cost of capital relates to the excess earnings method of valuation. The balance of the book describes, among other subjects, a variety of issues that arise in ascertaining the cost of capital in estate and gift matters; corporate restructurings and other federal tax matters (including transfer pricing); intellectual property and other damage disputes; bankruptcy filings; appraisal, oppression and fairness cases; family law matters; ad valorem taxation matters; and regulated industries issues.

Additional authors have selected chapters in the new book, increasing the importance of its contribution to the field of valuation. In chapter 6, Prof. Robert M. Lloyd (Lindsay Young Distinguished Professor, University of Tennessee College of Law) deals with the cost of capital included in damage calculations, presenting a well-supported conclusion that using the risk-free discount rate to calculate damages is inappropriate and the proper discount rate to employ is the cost of capital. Professor Lloyd further notes that the discount rate should be based on the risk characteristics of the particular risk or project that sustained the loss. Because so many courts have unjustifiably allowed damages to be based on an a risk-free rate, the valuation professional must, in addition to professionally valuing the assets or entity, clearly justify why the chosen discounted rate must be used. Support for such a justification is found in the same chapter.

In Chapter 8, Bernard Pump (Deloitte partner and valuation expert who worked with AIRA in the development of the CDBV program) discusses the cost of capital for debt, assets and business enterprises in bankruptcy. Pump deliberates the extent to which the Supreme Court decision in *Till* (541 U.S. 465) –advocating in the context of a chapter 13 case a formula approach (based on the prime rate of interest plus a risk adjustment (1.5%)– may be used to determine whether the interest rate in a cramdown plan is appropriate. Other recent cases wherein courts have addressed issues impacting the determination of cost of capital are discussed.

A very comprehensive list of questions that should be asked of business valuation experts is presented in Chapter 13. This list will certainly be used by opposing attorneys in questioning the valuation professional's assessment, and the benefits of preparing for these questions are difficult to overestimate. This list contains essential questions the business valuation expert should consider both in valuing the subject (assets or business) and in preparing for the deposition.

In conclusion, *Cost of Capital in Litigation* is comprehensive, straightforward and highly relevant, an outstanding resource for any professional involved in valuation issues in bankruptcy. AIRA is making it available to members at 20 percent off the list price. Advance orders can be placed at www.aira.org.



Letter from the President

Stephen Darr, CIRA, CDBV, CPA
 Mesirow Financial Consulting LLC

The end of September ushered in an event of some magnitude for the Association: I am pleased to announce the new AIRA website is now up and running, after several months of intensive effort by AIRA's Director of Information Technology, Bryan Anderson. The site has a new Web 2.0 look and feel, with streamlined menus and quicker access to Certification and Education resources. Although more changes and improvements are in the works, the main goals of having an effective platform that delivers more information, is easier to navigate, and is more intuitive, have been met. Check it out at www.AIRA.org.

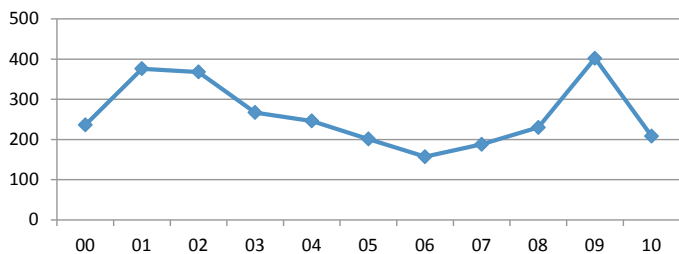
One of the themes of AIRA's leadership in the coming year will be continued dedication to supporting and strengthening its programs for professional education and certification. The Certified Insolvency & Restructuring Advisor (CIRA) and Certification in Distressed Business Valuation (CDBV) programs are an essential aspect of serving and advancing the field as a whole and our members in particular. The CIRA program was initiated in 1992 and is now near the completion of its 18th year. Former AIRA President James Lukenda in 2003 stated a fact about the CIRA program that helps explain the increase in the excellent reputation of this certification year after year: "The value of the CIRA is reinforced to its holders each time a CIRA undergoes voir dire. Judges and lawyers alike recognize the special skills of the professional who is a CIRA" (President's Letter, AIRA News, April/May 2003).

The Board of Directors recognizes the accomplishment and dedication of every individual who has made the commitment to certification, and encourages others to consider this important enhancement to their careers. In the CIRA program, a cumulative total of 1,227 certificates

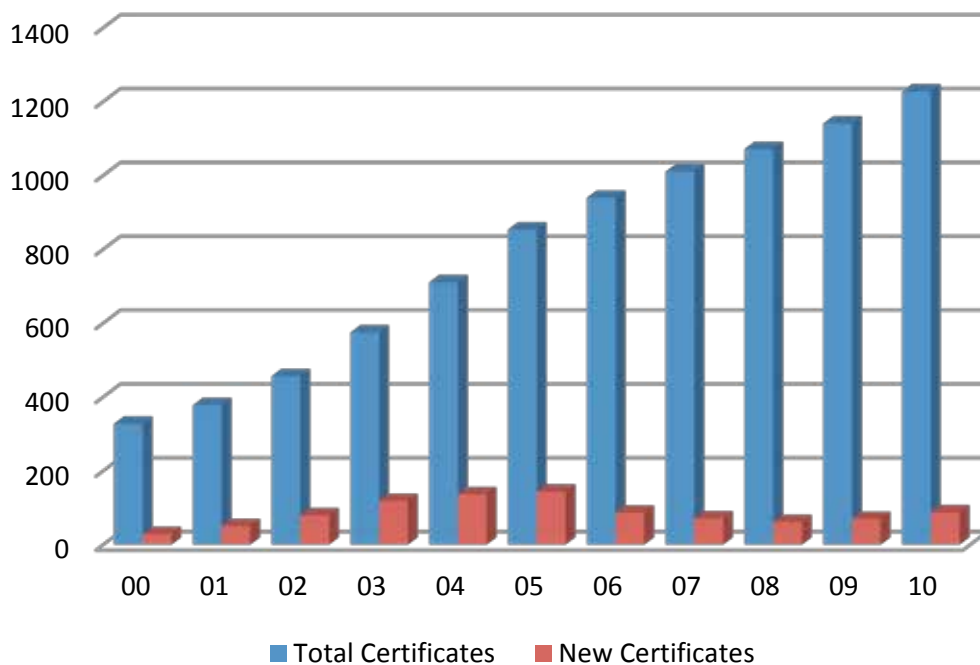
have been issued to date, 87 of them in 2010. Currently, 542 candidates have passed all three parts. The chart at lower left shows the number of new and cumulative total of CIRA certificates issued for 2000-2010; the chart at upper left displays the number of new registrants entering the CIRA program per year for 2000-2010.

President continues on p. 3

**New CIRA Program Registrants
 2000-2010**



**CIRA Certificates Issued
 New and Cumulative Total by Year
 2000-2010**



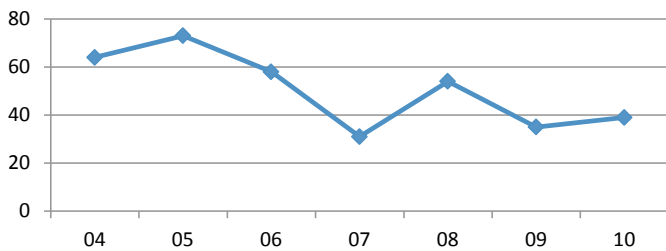
The Board of Directors in 2003 considered a proposal for enhancements to the CIRA program in the area of business valuation. A planning committee, chaired by Tracy Gopal and Bernard Pump worked for the next year to define body of knowledge, develop standards and curriculum for a new and separate designation, the CDBV. The intent was to complement the credentials of CIRAs with special preparation and recognition of professionals capable to render services in valuation of distressed businesses. In 2004, after reviewing the final materials for CDBV training and certification, President Jim Lukenda described it as rigorous and comprehensive. He also said the program “will enhance the professional standing of CIRAs and communicate to the restructuring community that . . . CDBVs have specialized expertise in this area. The program initially consisted of two

parts, but was soon modified and expanded to the current three part structure.

During the summer of 2010, AIRA reached the 6 year milestone of the CDBV program. A cumulative total of 90 CDBV certificates have been issued to date, 102 candidates have passed all three parts, and a cumulative total of 362 candidates have registered for the program. The chart below shows the number of new and cumulative total of CDBV certificates issued for 2005-2010; the chart at left displays the number of new registrants entering the CDBV program per year since its inception in 2004.

In closing I would like to mention the initial meeting of the AC 2011 Planning Committee that took place on September 27, at the InterContinental Boston Hotel, site of AIRA’s 27th Annual Bankruptcy and Restructuring Conference, June 8-11, 2011. The meeting involved the participation of many top professionals representing a broad spectrum of practice areas; it was exciting to see the framework for another outstanding conference rapidly begin to take shape and direction. Updates on the AC 2011 in Boston will be forthcoming soon.

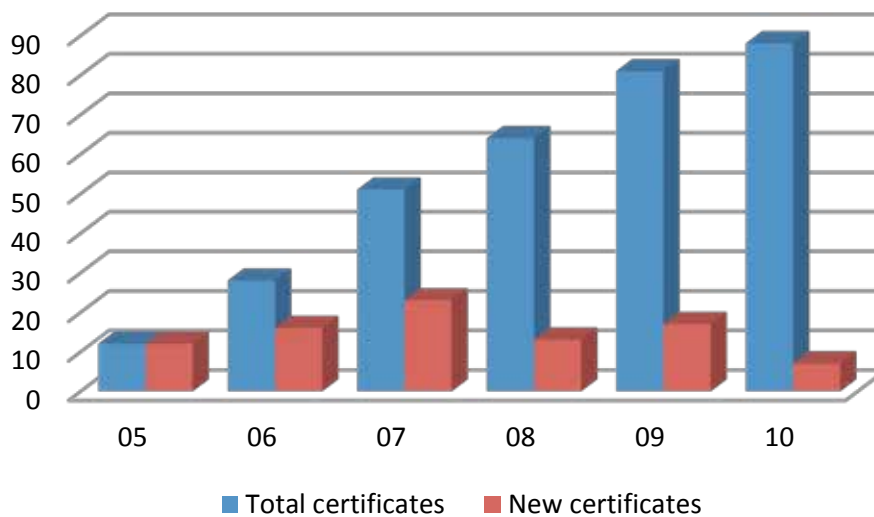
**New CDBV Program Registrants
2004-2010**



Wishing you the best,

Stephen Darr, CIRA, CDBV, CPA

**CDBV Certificates Issued
New and Cumulative Total by Year
2000-2010**



Steve Darr is a Senior Managing Director of Mesiraw Financial Consulting’s Boston office, providing financial consulting services to businesses experiencing significant financial and operating difficulties, typically with deteriorating relationships with creditors and suppliers. Mr. Darr has served DIPs, secured and unsecured creditors, bondholders and others, and as interim management in various industries.

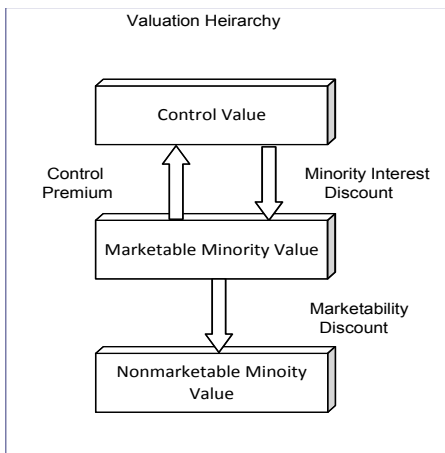
value that can be ascribed pro-rata to individual shares of stock or a minority ownership holding). If the results of these valuation approaches are going to be weighted or averaged by the appraiser to develop a final conclusion, the appraiser should convert all values to the same hierarchy (usually control value) to ensure comparability.

The Transaction Multiple Approach

The Transaction Multiple Approach is premised on the theory that the relationship between the selling price of a recently acquired enterprise and its cash flow (or some other business metric) within a certain industry can be used to value other similar companies in the same industry. For example, if eight furniture retail chains recently sold for an average of 10 times EBITDA, an appraiser may assume that investors will also pay 10 times EBITDA for the subject company. In this simplified example, each of the eight sample transactions involved the transfer of 100% of the business, or a controlling interest. Accordingly, the valuation conclusion under the Transaction Multiple Approach represents a control value of the subject business. The application of a control premium in this instance is not required.

The Discounted Cash Flow Approach

The Discounted Cash Flow Approach utilizes projected cash flows of the company to determine enterprise value. Specifically, the future cash flows of the company are discounted to a present value using a risk-adjusted discount rate (the weighted average cost of capital, or “WACC”). If the projected cash flows and the WACC are derived using assumptions that reflect control decisions and the optimal (market) capital structure, the resulting enterprise value is a control value and no premium is required. If, however, the projections and capital structure assume no change from the current operations, the results of the analysis will generate a marketable minority interest. The appraiser, in the latter instance, should consider the application of a control premium to assess the value of the business as a whole (a controlling interest) and to harmonize the results with other valuation approaches.



The Guideline Company Approach

In contrast to the Transaction Multiple Approach which analyzes recent sales of business enterprises, the Guideline Company Approach incorporates the individual share prices of comparable public companies in the same industry as the subject company. Because the individual shares of comparable public companies do not represent a control position or carry with them the “bundle of rights” enjoyed by majority owners, the Guideline Company Approach is assumed (by most analysts) to result in a marketable minority interest. As such, a control premium, in theory, would need to be applied to the computed enterprise value to convert the result to a control value.

III. Criticisms, Alternate Theories and Considerations

A. Empirical Data

While it is logical to assume that an investor, in normal circumstances, would ascribe value to the rights associated to a control position, it is very difficult to prove. Asset purchase agreements and stock purchase agreements do not distinguish between the marketable minority and control components of the purchase price. Analysts generally rely upon the empirical data available from public transactions as captured and published by Mergerstat® / Shannon Pratt's Control Premium Study™. Critics of this study caution that blind application of the means and medians contained in the study can result in misleading conclusions.

Strategic Premium -The Mergerstat database analyzes thousands of public

company transactions by Standard Industrial Classification (“SIC”) code. The premiums paid in these transactions over the prior market capitalization of the company were not, in every case, caused by the benefits of control. Other circumstantial factors can have a material impact over the price paid for a company. Investors involved in a bidding war or who perceive strategic synergies in the proposed transaction will often pay substantially higher prices than the market capitalization of the target company. These types of influences are difficult to isolate in the dataset for purposes of developing a control premium. In addition, it would not be appropriate to assume that the subject company in every case will garner competing bids or have a strategic value to potential purchasers in determining its fair value. For these reasons, analysts should assess the market environment of the subject company before selecting a control premium.

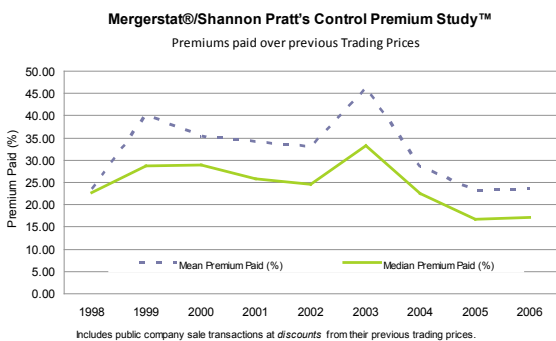
Biased Data Set - It is logical to assume that investors will pursue corporate targets that they believe are undervalued by the stock market. This phenomenon, some would argue, creates an inherent bias in the Mergerstat dataset because the companies that are properly valued by the stock market, or those that are overvalued, are not acquired. Therefore limiting the dataset to only public company acquisitions creates bias in the data that could potentially overstate the control premium as calculated.

Selection of Central Tendency - From 1998 to 2006, approximately 15% of corporate acquisitions actually had negative control premiums, which means the target was purchased at less than its prior market capitalization. Mergerstat is careful to provide means and medians both with and without the negative control premiums; however, analysts are divided on whether it is appropriate to include the negatives. Furthermore, the mean (average) control premiums are invariably higher than the median control premiums because the mean values are increased by outliers (usually resulting from acquisitions involving a bidding war or significant synergic value). Analysts

usually select the median values to eliminate the impact of outliers in the dataset.

is in very poor financial condition relative to its peers, the appraiser may decide that a control premium is not appropriate or that the magnitude

* Court did not rule on the issue. See accompanying narrative below.



of the control premium should be adjusted to reflect perceived value of control that would be adopted by a hypothetical purchaser.

These compelling criticisms, alternate theories, and considerations are the foundation of the subjective nature of the control premium issue. Like many aspects of business valuation,

the individual circumstances of each valuation assignment need to be carefully evaluated by the appraiser. The selection of a control premium, if applied, should be well-reasoned in the context of what a likely purchaser would adopt as of the measurement date for the subject valuation.

A. Plan Confirmation

In plan confirmation battles, proponents for the use of control premiums (equity holders) argue that enterprise value must reflect the value of control to properly quantify the value available to distribute under the plan and to harmonize the results of different valuation approaches. Objectors (pre-petition creditors) contend that the value received by creditors through the distribution of reorganized equity is in fact a minority interest; therefore, no control premium should be applied. Creditors rely heavily on the absolute priority rule when making their arguments. Creditors encourage the Court to compare the value of the individual shares received to the allowed amount of their pre-petition claim (with interest) to see if the absolute priority rule has been satisfied under the plan.

B. The Nath Theory

In contrast to conventional wisdom, appraiser and author Eric W. Nath posits an interesting theory that the Guideline Company Approach generates a control value and that applying a control premium is not necessary. His theory is based on the notion that if stock prices reflect a discount from the value of the public company as a whole, then takeover activity would soar.

“The fact that there are hundreds of billions, and perhaps trillions of dollars scouring the market for acquisition targets (LBO funds, domestic and foreign strategic buyers, and the bankers who fund them) makes it inconceivable that any good takeover opportunity will remain unmolested for long. As blood attracts sharks, a significant difference between the current price of a stock and its value to a controlling owner should trigger some form of takeover attack.”

III. Legal Application in Bankruptcy

Bankruptcy courts are divided on the issue of control premiums in plan confirmation and solvency matters. In some instances, the courts rule on the issue of control premiums based on the financial theories described above and, in other instances, the courts determine the issue as a matter of law. In each of the seven cases profiled below, the courts heard lengthy testimony from credentialed witnesses on the issue of valuation and the use of control premiums. As illustrated, however, the final rulings among the courts are inconsistent which further illustrates the subjective nature of the exercise.

In *Nelson Nutraceuticals*, the U.S. Bankruptcy Court District of Delaware issued a comprehensive opinion regarding the enterprise value of the debtor after hearing extensive testimony from three valuation experts. Only one of the three experts applied a control premium (30%). The Court weighted the valuation results of the three experts based on a variety of factors. Ultimately, the Court assigned the greatest weight to the valuation that included the 30% control premium.

“Mr. Braun was the only expert that applied a “control premium” in

C. Factors That Influence the Value of Control

Before a control premium is applied to a marketable minority interest value, the appraiser should evaluate the legal structure, the regulatory environment, the contractual obligations (buy sell agreements), and the financial condition of the company. These and other factors can significantly impact or even eliminate the value an investor would ascribe for control. For example, if a company is highly regulated, or

connection with his comparable company analysis... That 30% premium increased the resulting multiples (including EBITDA) derived and used in his comparable company analysis. Thus notwithstanding his departure from the use of a median value, Mr. Braun’s use of a multiple of 8.5 x LTM EBITDA in his Comparable Company analysis is both reasonable and

| | Case Name | Case No. | Matter | Control Premium Applicable? |
|---|-------------------------------------|----------------|----------------------|-----------------------------|
| 1 | Nelson Nutraceutical, Inc. | 06-10072 (CSS) | Plan Confirmation | Yes |
| 2 | Smurfit-Stone Container Corporation | 09-10235 (BLS) | Plan Confirmation | Yes * |
| 3 | Spectrum Jungle Labs Corp. | 09-50455 (RBK) | Plan Confirmation | No |
| 4 | Payless Cashways, Inc. | 01-42643 (ABF) | Solvency \$547/\$548 | No |
| 5 | ASARCO LLC | 05-21207 () | Equiv. Value \$548 | No |
| 6 | Heilig-Meyers Company | 00-34533 (DOT) | Solvency \$547/\$548 | No |
| 7 | TOUSA, Inc., et al. | 08-10928 (JKO) | Solvency \$547/\$548 | No |

intertwined with his use of a control premium. Thus his conclusion will not be disturbed by the Court.”

In *Smurfit-Stone Container Corporation*, the Court conducted a 10-day valuation hearing and heard testimony from eight expert witnesses. Equity holders argued that a control premium was required to reflect the true value of the enterprise and the assets to be distributed. The Creditors argued that the control premium issue in this context is a matter of law. Creditors pointed out that under the proposed plan, no creditor was receiving a sufficient amount of equity in the plan to exert control; therefore, no premium should be applied. The matter was settled by giving pre-petition equity holders a four percent ownership in the reorganized debtor. The Court was not required to rule specifically on the control premium issue; however, the party’s perceived risk of litigation on the matter resulted in a settlement that supports the use of a control premium.

In *Spectrum Jungle Labs Corp.*, the use of a control premium was rejected by the Court. The equity holders argued that, because noteholders collectively were receiving a 70% to 80% controlling interest in the reorganized debtor under the proposed plan, a control premium should be applied. In this instance, the Court was persuaded by the creditors’ argument that no individual creditor was receiving a controlling interest in the debtor, and that there was no agreement in place among the noteholders to act jointly. In issuing its opinion, the Court:

“disagree[d] with the Equity Committees’ fundamental assumption that the possibility of joint action is sufficient to mandate a finding of control and inclusion of a control premium.”

B. Solvency and Reasonably Equivalent Value – §547 / §548

Not surprisingly, when involved in solvency disputes, creditors are much more accepting of control premiums. In avoidance actions, where the establishment of solvency is an absolute

defense to both fraudulent conveyance and preference litigation, creditors contend that the application of a control premium is required because the Court is interested in the value of the entire enterprise (not a small block of the debtors’ shares). Notwithstanding the logic in the creditors’ position, the courts are divided on the control premium issue in solvency matters as well.

In *Payless Cashways, Inc.*, a consortium of creditors engaged counsel and financial experts, including the author of this article (Guy Davis), to defend against a \$100 million portfolio of preference actions. Specifically, Mr. Davis determined the fair market value of the business enterprise as a component of the solvency analysis during the 90-day period. In developing his conclusions, Mr. Davis applied a control premium to the multiples identified in the comparable (guideline) company analysis. The Court accepted Mr. Davis’ analysis and ultimately concluded that the debtor was solvent for the first 67 days of the preference period.

“[M]r. Davis looked at Payless’ EBITDA for the trailing twelve months. He then developed industry multiples...from what he considered nine comparable companies. He averaged the multiples, adjusted upwards for the premium purchasers would pay for a controlling interest, and downward for Payless’ relative position versus the industry. [B]ased on my evaluation, ...I will adopt Mr. Davis’ report for the Comparable Company Approach.”

It is noteworthy that Mr. Davis applied a control premium to the multiples gleaned from the stock price of comparable public companies, but also a discount for the relative position of the debtor versus the industry. Appraisers will sometimes offset an otherwise valid control premium with a discount for financial condition as a justification for using the unadjusted guideline company multiple. Mr. Davis elected to itemize the two adjustments for clarity.

In *ASARCO LLC.*, the debtor filed suit to recover as a fraudulent conveyance a 54.18% share in Southern Peru Copper

Company (“SPCC”). The Court issued a very comprehensive analysis and ruling that specifically addressed the control premium issue and the factors that could potentially affect its application (see discussion in Section III C of this article). Similar to the ruling in *Payless Cashways*, the Court ultimately decided that a 20% control premium was appropriate, despite the defendants’ three-pronged argument that a control premium should not be applied. The defendants argued that:

1. The pre-existing shareholder agreement impairs the ability of a prospective investor to gain control.
2. A new controlling shareholder would not be able to improve upon the cash flows currently generated under existing ownership.
3. A control factor is already embedded in the stock price because a controlling shareholder already exists.

Each of these arguments were analyzed and addressed in the Court’s Memorandum Opinion. The Court stated that the events that would need to take place to block control under the pre-existing shareholder agreement were unlikely to occur and very speculative. The Court also found that the plaintiffs’ failure to identify the specific measures that a new controlling shareholder would take to improve cash flows does not negate the need for a control premium. Lastly, the Court reasoned that the hypothetically elevated stock price caused by the existence of a controlling shareholder does not capture the control value that would extend to a new purchaser of a controlling block of stock. For these reasons, the Court rejected the defendant’s arguments and determined that a 20% control premium was appropriate under the circumstances.

In *Heilig-Meyers Co., Inc.*, the debtor sued Wachovia Bank to avoid a \$250 million lien on the assets of Heilig-Meyers obtained by the bank in the 90-day period prior to bankruptcy. Wachovia retained an expert who successfully convinced the Court that Heilig-Meyers was solvent on the date of the transfer. In developing its opinion,

however, the Court rejected Wachovia's expert's use of a control premium in the application of the Guideline Company Approach. The Court acknowledged the widely accepted theory of control premiums found in valuation text books, but did not believe that those theories apply in valuations performed in a recovery action under §547 of the bankruptcy code.

"Further undermining his market multiple approach in the court's view is Greenspan's insistence on increasing his base market multiple calculation by adding in the value of a premium for control. As explained in his report, a premium for control of a business's enterprise value is based upon the value of its assets as a going concern on a debt free basis and represents the additional amount a potential investor would pay in order to control the company. Again, the court accepts this computation as a valid methodology recognized by the text books. However, this court finds it difficult to relate an investor's purchase of control of debtors' enterprise value to a valuation under Bankruptcy Code § 547. Moreover, the court cannot grasp the appraiser's premise that in this case a real investor could have purchased debtors' operating assets completely without regard to the complex debt structure. It is too theoretical to be useful under the present record."

In TOUSA, Inc., the Creditors' Committee sought to avoid approximately \$500 million in liens transferred to lenders within six months of the bankruptcy and a \$207 million security interest granted in a tax refund within 90 days of the bankruptcy filing. The plaintiffs engaged a solvency expert that opined convincingly that the application of a control premium was not appropriate under the circumstances. The expert argued that the intent of his analysis was to determine the value of the business in its current state under current ownership, not the value of the company to potential investors. The Court heartily accepted the plaintiff's position that the application of a control premium was inappropriate, despite the defendant's argument that a purchaser would pay more for majority control of the company

(leaning on the "willing buyer, willing seller" analysis, which is the foundation of the fair market value standard). The Court also dismissed the control premium issues as irrelevant in this case because the control premium (if applied) would have to be greater than 110% for TOUSA to be solvent.

"I furthermore note that an additional criticism of [the Observable Market (or Guideline Company)] method raised by Defendants at trial regarding Derrough's decision not to apply a "control premium" to the market value of TOUSA's stock is not only factually baseless for reasons I have already stated but is also legally groundless. [T]he premium a hypothetical investor might theoretically pay to purchase a controlling share of TOUSA's stock is irrelevant to computing asset values under Section 548. Heilig-Meyers Co. v. Wachovia Bank, [*861] N.A. (In re Heilig-Meyers Co.), 319 B.R. 447, 462 (Bankr. E.D. Va. 2004)."

IV. Conclusion

The basic notion that a minority interest in a business enterprise is worth less than the ratable share of a controlling interest is not disputed by the Courts or valuation professionals. Even Mr. Nath agrees that control values should be discounted to determine the value of minority interests. The challenge arises in determining the circumstances in which it is necessary for an appraiser or the Court to apply a control premium from a financial and legal perspective and, if applied, how large the adjustment should be. Legal and financial debates contain intellectually stimulating arguments that both support and invalidate the use of a control premium in various circumstances. As the judicial system, in part, relies on experts to advise the Court of the financial theory supporting all aspects of their valuation exercise, it is incumbent upon the experts to clearly explain the rationale behind their use or non-use of a control premium. An expert that invariably applies a standard control premium in all valuation exercises has not properly considered this important issue. As demonstrated in the cases profiled herein, the control premium issue, in some instances, can render a plan

unconfirmable or, in the context of chapter 5 avoidance actions, determine the difference between solvency and insolvency. ■

1. *Pratt, Shannon P. and Niculita, Alina V., Valuing a Business : The Analysis and Appraisal of Closely Held Companies, 5th ed., New York : McGraw Hill, 2008, p. 385.*
2. *Id. p. 385*
3. *Mergerstat® / Shannon Pratt's Control Premium Study™, Santa Monica: FactSet Mergerstat LLC, 2006, www.mergerstat.com.*
4. *Pratt, Shannon P. and Niculita, Alina V., Valuing a Business : The Analysis and Appraisal of Closely Held Companies, 5th ed., New York : McGraw Hill, 2008, p. 392.*
5. *Id. p. 228*
6. *The control premium is applied to the equity portion of enterprise value.*
7. *Id. p. 390*
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Guy A. Davis is a Managing Director with Protiviti Inc. and manages the firm's Richmond, Virginia office. He has nearly 18 years of accounting, finance and consulting experience in the areas of corporate restructuring, commercial litigation, financial investigations, and valuation.

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Mr. Davis has performed a variety of financial advisory and fiduciary services to bankrupt or distressed entities, their lenders and unsecured creditors including: operations management, asset liquidation, debt restructuring, asset recovery, fraud investigation, solvency analyses, and business valuation. He has: 1) prepared plans of reorganization, liquidation analyses, and analysis of recoverable transfers; 2) served as acting CFO of debtor organizations, Chief Liquidation Officer, court approved claims and disbursing agent, and accountant to chapter 7 trustees; and, 3) provided expert witness testimony before eight U.S. Bankruptcy Courts in Virginia, Delaware, South Carolina and Missouri and several circuit courts. Mr. Davis has performed numerous business valuations for use in bankruptcy, estate planning, purchase and sale of business, divorce settlements, litigation and loan collateral analysis. These valuations were for hotels, restaurants, printing companies, medical practices, construction contractors, distributors, manufacturers, retailers and others.

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Bankruptcy Taxes

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A CAUTIONARY TALE: TRUSTEE AND DEBTOR BOTH END UP PAYING

A bankruptcy case which spilled over into a Tax Court case demonstrates the tax risks for both trustee and debtor when taxable income is not correctly identified and tax returns are not filed. Amy Jeffries was an employee of Wal-Mart Corporation in Ohio who felt that she had been discriminated against in employment and filed a Civil Rights action against the corporation. Though the trial court awarded her \$552,000 in damages and interest in 1998, Wal-Mart appealed and the case dragged on for years. During the period of protracted litigation, Ms. Jeffries felt compelled to file a petition in Chapter 7 in 1999 but the IRS was not listed as a creditor. In 2001, the Sixth Circuit upheld the judgment and Wal-Mart paid up. Distributions were made to Ms. Jeffries in the amount of \$200,000 and \$54,000. A trustee fee of \$18,000 was paid and the balance of the funds went to pay off creditors and presumably attorney fees from the protracted litigation. The Ch. 7 case was closed in 2004.

For some reason no tax returns were ever filed for the bankruptcy estate despite the fact that legal damages arising from employment causes of action are generally treated as taxable income for federal purposes. On her 2002 individual tax return Ms. Jeffries reported \$232,000 of trust distributions plus \$126,000 of interest income. [That tax may not have been paid with the return—FL.] She then turned around in 2004 and filed an amended return reducing her 2002 gross income by \$311,000 relying on Revenue Ruling 78-134 which holds that merely returning the residue of a bankruptcy estate to a debtor is not taxable. [Perhaps an attempt to abate the unpaid 2002 liability?—FL.] This apparently prompted IRS in 2005 to audit the 2001 bankruptcy estate and assess federal income tax of \$116,000 plus \$30,000 in penalties to the bankruptcy estate. Since the bankruptcy case was closed, IRS then assessed tax of \$118,000 plus penalties of \$60,000 against Ms. Jeffries under a transferee liability theory.

Ms. Jeffries responded both by contesting the transferee liability assessment in Tax Court and reopening the bankruptcy case in an attempt to get a favorable ruling there. Ultimately the Tax Court ruled:

1. It had the jurisdiction to determine these tax issues as they had not been determined by the Bankruptcy Court.
2. It upheld the transferee liability assessments against Ms. Jeffries.
3. It held that under Ohio law, IRS could proceed against Ms. Jeffries without previously exhausting all remedies against the Trustee.

The Trustee was ordered by the Bankruptcy Court to disgorge his \$18,000 fee to IRS and the State of Ohio. At the time the Tax Court opinion was issued, IRS was still pursuing its right to collect the remainder of the tax and penalty from the Trustee, presumably if it did not succeed in collecting those from Ms. Jeffries.

Conclusion—Three lessons emerge from this case: (1) it is important for Trustees to protect themselves by properly identifying taxable income and filing returns in the cases they are administering; (2) even if the Trustee fails to properly report taxes at the bankruptcy estate level, the debtor can still be on the hook and should not close their eyes to what happens at the Trustee level; (3) IRS may have been satisfied to collect the tax from the debtor via the 2002 individual income tax return even though it should have been a bankruptcy estate level liability; however, the 2004 amended return trying to avoid the 2002 tax liability motivated IRS to audit and go after all possible parties. The taxpayer may have overreached with the 2004 amended return trying to eliminate the tax. ■

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

CIRCUITS CLASH ON FARM SALE TAX

The U.S. Court of Appeals for the Ninth Circuit recently held that Chapter 12 farm bankruptcy debtors could not treat capital gains taxes arising from the post-petition sale of their farm as an unsecured claim that is not entitled to priority and therefore was to be partly discharged, because in their view a Chapter 12 estate cannot incur tax (*United States v. Hall*, 9th Cir., No. 08-17267, 8/16/10). This holding is at odds with the Eighth Circuit's 2009 ruling in *Knudsen v. IRS*. In that case the court held that income taxes arising from the post-petition sale of assets are unsecured claims and are dischargeable.

At the heart of the issue is whether a Chapter 12 farm bankruptcy estate can incur taxes. The Ninth Circuit based its ruling on Internal Revenue Code Sections 1398 and 1399 which say that no separate taxable estate is created in Title 11 cases except in "any case under chapter 7 (relating to liquidations) or chapter 11 (relating to reorganizations) of title 11 of the United States Code in which the debtor is an individual." (Generally, no separate taxable estate is created in Ch. 11 business cases or in Ch. 13 cases for wage earner bankruptcies). The court reasoned that if no separate taxable estate could be created, then the tax liability must be that of the debtor. Since the taxes were not "old and cold," i.e., due at least three years before the petition date, they could not be discharged. The opinion went into a detailed analysis of the relationship between Bankruptcy Code Sections 1222 on Ch. 12 reorganization plans and 507 on priority taxes, which will not be repeated here.

Brenda and Lynwood Hall filed a bankruptcy petition in August 2005 under Chapter 12 and shortly after filing, the Halls moved to sell their farm for \$960,000 which

the bankruptcy court approved. In December, 2005, the Halls proposed a plan of reorganization under which they sought to pay off their outstanding liabilities using the proceeds of the sale of their farm. IRS objected to the plan, claiming they owed \$29,000 in capital gains taxes on the sale. The couple then amended their proposed plan to treat the \$29,000 as an unsecured claim to be paid to the extent the funds were available and discharging the balance. IRS objected to the amendment, and the bankruptcy court sustained the objection. The case was litigated up the line eventually resulting in the Ninth Circuit decision which rejected, with one dissent, the reasoning used by the Eighth Circuit in *Knudsen*. The Ninth Circuit held that since there could be no separate bankruptcy estate for tax purposes, the Halls were liable for the tax.

The Eighth Circuit's holding in the *Knudsen* case is probably best summarized by the dissenting judge in the Hall case:

"In my view, Congress's intent was clear: it wanted to help family farmers keep their farms by allowing them to sell farm assets to pay off debts without being liable for the full amount of any capital gains tax arising from the sale, regardless of whether they sold the assets before or after filing their Chapter 12 petition. Rather than follow the course proposed by the majority, I would follow the reasoning of the Eighth Circuit in *Knudsen v. IRS*..."

We now have a clear conflict between the circuits. Usually, but not always, these disputes between the circuits are resolved by an eventual Supreme Court decision. Time will tell how this one turns out. ■

IRS LIBERALIZES POSITION ON DISCHARGE OF LATE FILED INDIVIDUAL RETURNS

As reported in this column in the February-March 2010 issue, practitioners have been very concerned about a little known provision 2005

provision Congress inserted into the Bankruptcy Code section that controls discharge of certain taxes for individuals. The IRS has interpreted this provision to mean that the underlying tax return must be timely filed in order for taxes to be discharged. The relevant tests of dischargeability for income taxes (the "old and cold" tests):

- (1) the date a tax return for the period was last due (including extension) was more than three years prior to the date of the bankruptcy filing (Bankruptcy Code §§ 523(a)(1)(A) and 507(a)(8)(A)(i));
- (2) no new assessments of tax for the period have been made in the 240 days preceding the filing (Bankruptcy Code §§ 523(a)(1)(A) and 507(a)(8)(A)(ii));
- (3) a return was filed for the applicable period more than two years prior to the filing (Bankruptcy Code §§ 523(a)(1)(B)(i) and (ii))

Here is the exact wording that was added as an unnumbered paragraph at the end of Section 523(a): "For purposes of this subsection, the term "return" means a return that satisfies the requirements of applicable nonbankruptcy law (including applicable filing requirements)."

The problem arises from the parenthetical "(including applicable filing requirements)". The IRS has argued successfully in two post-2005 bankruptcy court cases that the parenthetical language means the return has to be timely filed (In Re: Jeffrey Links docket no. 08-3178 (Bankr. N.D. Ohio); In re Creekmore, 401 B.R. 748 (Bankr. N.D. Miss. 2008)). Fortunately, the Office of the IRS Chief Counsel is now backing away from the harsh position taken in those cases. In an advice issued recently, the Chief Counsel held that under a judicial doctrine established by the Supreme Court, the interpretation that the new wording requires that a tax return be timely filed in order to be potentially dischargeable is too radical a change from prior practice to be inferred when there is no mention of it in the Congressional legislative record (CC

2010-016, see below). The opinion clearly states that individual income taxes that are self-assessed in a late filed tax return meeting all three tests above can be discharged in bankruptcy (see Example 1 below). Thus, the IRS expressly gives away ground that it won in the Creekmore case.

The Chief Counsel's advice goes on to make a distinction between taxes assessed by IRS and those self-assessed by a taxpayer filing a tax return, including a late tax return. Assume that an individual taxpayer has failed to file Form 1040 for a given year when the person had taxable income and a federal income tax liability. The IRS will sometimes assess tax based on an audit it conducts of the person's financial affairs or from information returns it has received, usually Forms W-2 or 1099, in a "document matching procedure." The Chief Counsel's advice says that tax assessed by the IRS before the filing of any late return by the taxpayer cannot be discharged. However, if the taxpayer files a tax return showing an additional liability after the IRS assessment, that additional tax could potentially be discharged (see Example 3 below).

Illustrative Examples

Example 1—John Smith fails to timely file his 2009 Form 1040. After receiving several letters from IRS asking for his 2009 tax return he files a return for 2009 on October 30, 2011 showing a federal income tax liability of \$10,000 which he does not pay despite receiving collection notices thereafter. On November 12, 2013, he files a petition in Ch. 7 to liquidate his remaining assets and discharge his debts. Assuming there are insufficient assets to pay any unsecured general liabilities, the \$10,000 is dischargeable because it meets the "old and cold" tests mentioned above.

Example 2: Bob Thomas fails to timely file his 2009 Form 1040. The IRS commences an audit which results in an assessment for the 2009 year of \$20,000 on November 15, 2011. The IRS begins sending regular collection notices to Mr. Thomas which he does not pay. On December 1, 2013 Mr. Thomas files a petition in Ch. 7 to liquidate

his remaining assets and discharge his debts. According to the Chief Counsel Advice, the \$20,000 is nondischargeable in any event since no tax return was filed (BC 523(a)(1)(B)(i)).

Example 3: Mary Jones fails to timely file her 2009 Form 1040. Using 1099 document matching information for 2009 the IRS issues an assessment of \$5,000 on October 28, 2011. The assessment prompts her to catch up her tax returns and on November 10, 2011 she files a 2009 Form 1040 showing a total tax liability of \$18,000 but she does not have the money to pay it. The

IRS begins sending her regular collection notices, none of which she pays. On November 20, 2013 Ms. Jones files a petition in Ch. 7 to liquidate her remaining assets and discharge her debts. According to the Chief Counsel Advice, the \$5,000 is nondischargeable but the additional \$13,000 is dischargeable (\$18,000 - \$5,000 = \$13,000).

Conclusion: The position expressed in the new Chief Counsel Advice makes a lot more sense and is one that everyone can live with. Certainly it would apply in Ch. 7 individual cases. Presumably, an individual debtor operating a business who reorganizes

under Ch. 11 can also get a discharge for taxes if there are insufficient assets for payment of general, unsecured creditors and the taxes meet the terms of the Chief Counsel's Advice. The Advice would seem to have limited application to Ch. 13 «wage earners plans» as those generally require filing of all tax returns at the beginning of the case and the discharge, if any, is not granted until the end of the case, usually 3-5 years. ■

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

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Bankruptcy Cases

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BANKRUPTCY RULINGS ON CREDIT BIDDING

Third Circuit (In re Philadelphia Newspapers, LLC)

Under Code § 1129(b)(2)(A), is a secured lender legally entitled to credit bid at an auction sale pursuant to a reorganization plan?

In a split decision the Third Circuit held that 1) cramdown provision § 1129(b)(2)(A)(iii) permitted debtors to satisfy lenders' liens against assets of bankruptcy estate by conducting sale of collateral free and clear of liens and providing secured lenders with "indubitable equivalent" of their secured claims, and 2) cramdown provision's "indubitable equivalent" subsection unambiguously excluded lenders' right to credit bid at asset sale. *In re Philadelphia Newspapers, LLC*, 599 F.3d 298, Bankr. L. Rep. P 81,719 (3rd Cir.(Pa.) Mar 22, 2010).¹

The Debtors filed a Chapter 11 plan of reorganization (the "Plan"). The Plan provided that substantially all of the Debtors' assets will be sold at a public auction and that the assets would transfer free of liens. Debtors simultaneously signed an asset purchase agreement with Philly Papers (the "Stalking Horse Bidder").² A majority interest in the Stalking Horse Bidder was held by an insider Pension and Annuity Fund holding equity in the debtor. Under the Plan, the purchase

¹ On the same issue, the Fifth Circuit had previously held that although the reorganization plan involved a "sale" of noteholders' collateral, the plan could be confirmed as "fair and equitable" pursuant to § 1129(b)(2)(A)(iii) even if it did not offer noteholders an opportunity to credit bid for their collateral, if it offered them the realization of the "indubitable equivalent" of their allowed secured claims. *In re Pacific Lumber Co.*, 584 F.3d 229, 52 Bankr. Ct.Dec.46, Bankr. L. Rep. P 81, 642 (5th Cir. 2009). See comments on *Pacific Lumber* below.

² In the bankruptcy context, a stalking horse bidder reaches an agreement with the debtor-in-possession to purchase assets prior to the court-supervised auction of those assets. This bid will be exposed to higher and better bids at auction.

would generate cash for the Lenders and the Lenders would receive the Debtors' headquarters. The Lenders would receive any cash that generated by a higher bid at the public auction.

The Debtors filed a motion for approval of bid procedures in which the Debtors sought to preclude the Lenders from "credit bidding" for the assets.³ Instead, the Debtors insisted that any qualified bidder fund its purchase with cash. In their motion to the Court, Debtors stated the basis for their procedures:

The Plan sale is being conducted under section 1123(a) and (b) of the Bankruptcy Code, and not section 363 of the Bankruptcy Code. As such, no holder of a lien on any asset of the Debtors shall be permitted to credit bid pursuant to section 363(k) of the Bankruptcy Code.

Section 1129(b)(2)(A) provides three circumstances under which a plan can be crammed down pursuant to it being "fair and equitable" to secured creditors:

A) With respect to a class of secured claims, the plan provides—

(I) (I) that the holders of such claims retain the liens securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims; and (II) that each holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property.

(ii) for the sale, subject to section 363(k) of this title, of any property that is subject to the liens securing such claims, free and clear of such

³ A credit bid allows a secured lender to bid its debt in lieu of cash.

liens, with such liens to attach to the proceeds of such sale, and the treatment of such liens on proceeds under clause (I) or (iii) of this subparagraph; or [*emphasis added*]

(iii) for the realization by the holders of the indubitable equivalent of such claims.⁴

The Third Circuit Court was asked in this appeal to decide whether Section 1129(b)(2)(A) of the Bankruptcy Code requires that any debtor who proposes, as part of its plan of reorganization, a sale of assets free of liens must allow creditors whose loans are secured by those assets to "credit bid" their credit at the auction.⁵ The Third Circuit did not find that the debtor's proposed plan of reorganization provided the creditors with the "indubitable equivalent" of their secured claim, but instead endorsed the proposed bidding instructions for the sale that was contemplated by that plan. It left for further proceedings the determination of whether the plan did, in fact, provide the secured creditors with the indubitable equivalent of their claim.⁶ The Court reasoned:⁷

The three subsections of § 1129(b)(2)(A) each propose means of satisfying a lender's lien against assets of the bankruptcy estate. Subsection (I) provides for the transfer of assets with the liens intact and deferred cash payments equal to the present value of the lender's secured interest in the collateral. Subsection (ii) provides for the sale of the collateral that secures a lender free and clear of liens so long as the lender has the opportunity to "credit bid" at the sale (*i.e.*, *offset its bid with the value of its secured interest in the collateral*) with the liens to attach to the proceeds of the sale.⁸ Subsection (iii) provides

⁴ 11 U.S.C.A. § 1129(b)(2)(A).

⁵ 599 F.3d 298, 301.

⁶ 599 F.3d 298, 317-8.

⁷ 599 F.3d 298, 305.

⁸ The right to credit bid is found in § 363(k) and explicitly incorporated into subsection (ii). Section 363(k) provides:

At a sale under subsection (b) of this section of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if

for the realization of the claim by any means that provides the lender with the “indubitable equivalent” of its claim.

The Lenders concede, as they must, that § 1129(b)(2)(A) is phrased in the disjunctive. The use of the word “or” in this provision operates to provide alternatives—a debtor may proceed under subsection (I), (ii), or (iii), and need not satisfy more than one subsection. This approach is consistent with the definitions provided by the Code. Section 102(5) provides “that ‘or’ is not exclusive[.]” 11 U.S.C. § 102(5). The statutory note to § 102(5) further explains that “if a party ‘may do (a) or (b),’ then the party may do either or both. The party is not limited to a mutually exclusive choice between the two alternatives.” 11 U.S.C. § 102 hist. n. (West 2004) (Revision Notes and Legislative Reports); see also H.R.Rep. No. 95-595, at 315 (1977) as reprinted in 1978 U.S.C.C.A.N. 5963, 6272; S.Rep. No. 95-989, at 28 (1978) as reprinted in 1978 U.S.C.C.A.N. 5787, 5814. Thus, any doubt as to whether subsections (I), (ii), and (iii) were meant to be alternative paths to meeting the fair and equitable test of § 1129(b)(2)(A) is resolved by the Bankruptcy Code itself, and courts have followed this uncontroversial mandate. See, e.g., *Pacific Lumber*, 584 F.3d at 245 (affirming “the obvious proposition that because the three subsections of § 1129(b)(2)(A) are joined by the disjunctive ‘or,’ they are alternatives”); . . . ; accord *Corestates Bank, N.A. v. United Chem. Techs., Inc.*, 202 B.R. 33, 50 (E.D.Pa.1996) (“Courts consider Congress’ use of the disjunctive ‘or’ between subsections (I), (ii), and (iii) indicative of Congressional intent that only one of the three subsections need be satisfied in order to find a plan fair and equitable.”).

The Court reasoned that “it is apparent here that Congress’ inclusion of the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property.

the indubitable equivalence prong intentionally left open the potential for yet other methods of conducting asset sales, so long as those methods sufficiently protected the secured creditor’s interests. Accord *In re CRIIMI MAE, Inc.*, 251 B.R. 796, 807 (Bankr.D.Md.2000) (“11 U.S.C. § 1129(b)(2)(A) plainly indicates that subsections (I), (ii) and (iii) are to be treated as distinct alternatives.”)⁹

The Lenders argued that because the Plan includes a sale of collateral free and clear of liens, the Lenders would have a statutory right to credit bid pursuant to the express terms of subsection (ii).¹⁰ The majority opinion rejected this argument:

The Lenders’ argument in this regard elevates form over substance. A proposed plan of reorganization, even one that fully compensates lenders for their secured interest, would necessarily fail under their reading if the plan proposed a free and clear asset sale without complying with the additional requirements of subsection (ii). Reading the statute in this manner significantly curtails the ways in which a debtor can fund its reorganization—an outcome at odds with the fundamental function of the asset sale, to permit debtors to “provide adequate means for the plan’s implementation.” 11 U.S.C. § 1123(a)(5)(D); . . .¹¹

The bulk of the Lenders’ arguments, as well as the weight of the Bankruptcy Court’s reasoning, rely on the way in which §§ 1111(b) and 363(k) inform a lender’s right to credit bid at the sale of the debtor’s assets.¹² The Lenders argue that the Code guarantees a secured lender one of two rights—either the right to elect to treat their deficiency claims as secured under § 1111(b) or the right to bid their credit under § 363(k).

⁹ 599 F.3d 298 at 308.

¹⁰ 599 F.3d 298 at 306.

¹¹ 599 F.3d 298 at 308-9.

¹² [For an explanation of § 1111(b), see Dunaway, *The Law of Distressed Real Estate* § 29:82. “Section 1111(b)(2) election”-Westlaw Database LAW.DRE and John Collen, “Understanding the Section 1111(b) Election”, 19 J. Bankr. L. & Prac. 4 Art. 1(July 2010)].

Because the Lenders are statutorily precluded from making a § 1111(b) election,¹³ they contend that they must be afforded the right to credit bid at the auction.

At the heart of the Lenders’ argument is the notion that the combined import of § 1111(b) and § 363(k) is a special protection afforded to secured lenders to recognize some value greater than their allowed secured claim—either by treating their unsecured claim as a secured deficiency claim under § 1111(b), or bidding their credit under § 363(k) in hopes of realizing a potential upside in the collateral. Asserting an absolute right to such preferential treatment is plainly contrary to other provisions of the Code, which limit a secured lender’s recovery to the value of its secured interest even when it is not permitted to make a § 1111(b) election. [The majority cited examples.]¹⁴ Thus when a debtor proceeds under subsection (I), a lender who is ineligible to make a § 1111(b) election is still limited in its recovery to the judicial valuation of its secured interest in the collateral.¹⁵ A secured lender’s expectation of benefitting from the eventual appreciation of collateral (the so-called “upside” of the collateral) is not an entitlement when the property is part of a bankruptcy estate.¹⁶

The majority summarized the case:

Finally, our holding here only precludes a lender from asserting that it has an absolute right to credit bid when its collateral is being sold pursuant to a plan of reorganization. Both the District Court below and the Fifth Circuit in *Pacific Lumber* contemplated that, in some instances, credit bidding may be required. See 584 F.3d at 247. In addition, a lender can still object to plan confirmation on

¹³ Recourse lenders are exempted from making a § 1111(b) election. See 11 U.S.C. § 1111(b)(1)(B)(ii) (exempting secured lenders from exemption if “the holder of a [secured claim] has recourse against the debtor on account of such claim and such property is sold under section 363 of this title or is to be sold under the plan”).

¹⁴ 599 F.3d 298 at 316.

¹⁵ 599 F.3d 298 at 315-16.

¹⁶ 599 F.3d 298 at 316.

a variety of bases, including that the absence of a credit bid did not provide it with the “indubitable equivalent” of its collateral.¹⁷

Dissent

Third Circuit Judge Thomas L. Ambro wrote a lengthy dissenting opinion in which he disagreed with the majority’s fundamental conclusion that § 1129(b)(2)(A) is unambiguous. As such, it must be interpreted in context of the entire Bankruptcy Code, the legislative history, “and the comments of Code drafters.” Judge Ambro concluded that consideration of all of these sources leads to the conclusion that the Bankruptcy Code requires cramdown plan sales free of liens to fall under subsection 1129(b)(2)(A)(ii) rather than under the “general” requirement of subsection (iii). Judge Ambro’s dissent also addressed the right to credit bid in the context of the broader market. According to Judge Ambro, secured creditors have lawfully bargained pre-bankruptcy for unequal treatment and the right to credit bid is an important “consequence” of this lawful bargaining. In his view, the majority opinion increases the potential for a secured creditor to lose its right to credit bid and thus potentially “uproots settled expectations.”¹⁸

Fifth Circuit (*In re Pacific Lumber Co.*)

Can a Chapter 11 plan be confirmed as “fair and equitable” pursuant to § 1129(b)(2)(A)(iii) even if it does not offer noteholders an opportunity to credit bid for their collateral, if it offered them the realization of the “indubitable equivalent” of their allowed secured claims?

The Fifth Circuit holds that a Chapter 11 plan can be confirmed as “fair and equitable” pursuant to § 1129(b)(2)(A)(iii) even if it did not offer noteholders an opportunity to credit bid for their collateral, if it offered them the realization of the “indubitable equivalent” of their allowed secured claims. *In re Pacific Lumber Co.*, 584 F.3d 298 at 317.

18 Sam J. Alberts and David Lee Tayman, *Secured Lenders Do Not Have an Absolute Right to Credit Bid at Bankruptcy Plan*, 27 NO. 8 Bankr. Strategist 1 (June, 2010); Paul D. Moore, Hon. Mildred Caban, Jeffrey D. Ganz, Charles C. Reardon, John Ventola, *The Assault on the Secured Creditor*, 070810 ABI-CLE 31 (July 8-11, 2010).

F.3d 229, 52 Bankr.Ct.Dec.46, Bankr. L. Rep. P 81,642 (5th Cir. 2009).

The Third Circuit in *In re Philadelphia Newspapers, LLC*, summarized the holding in the *Pacific Lumber* case on essentially the same issue regarding the right to credit bidding as follows:¹⁹

On the other hand, the Fifth Circuit has specifically addressed whether a lender had a right to credit bid under subsection (iii) [§ 1129(b)(2)(A)(iii)] and concluded that it did not. *See Pacific Lumber*, 584 F.3d at 246. As discussed above, the court in *Pacific Lumber* confirmed a sale of assets at private auction by determining that the cash payout to the noteholders provided the “indubitable equivalent” of their secured interest in the assets, notwithstanding a provision barring secured lenders from credit bidding. 584 F.3d at 246. Though *Pacific Lumber* was a plan confirmation case, its holding on the threshold requirements of § 1129(b)(2)(A) speaks to our inquiry here—specifically, that a debtor may proceed with a sale under subsection (iii) without permitting secured lenders to credit bid. Accord *CRIMI MAE*, 251 B.R. at 807 (reasoning that § 1129(b)(2)(A) permitted a debtor to proceed with a sale free and clear of liens under subsection (ii) or (iii), and that because only subsection (ii) required credit bidding, a sale that proceeded under subsection (iii) need only satisfy the “indubitable equivalent” requirement).

Comments on Philadelphia Newspapers and Pacific Lumber Cases

“While the Court’s [*Philadelphia Newspapers*] construction of the statute does have a certain linguistic purity, it raises the very troubling question of just how one measures, much less assures, “indubitable equivalence” in the absence of a right to credit bid, especially if no lien is retained.”²⁰

19 *In re Philadelphia Newspapers, LLC*, 599 F.3d 298 at 312, Bankr. L. Rep. P 81,719 (3rd Cir. (Pa.) Mar 22, 2010).

20 John Collen, “Understanding the Section 1111(b) Election, 19 J. Bankr. L. & Prac. 4 Art. 1, FN 9 (July 2010).

“These decisions [*Philadelphia Newspapers* and *Pacific Lumber*] are important; in fact, they may be game changers in many bankruptcy cases and could affect investment decisions and interests in the distressed debt market. In bankruptcy cases, these decisions will shift some power (at least in the Fifth and Third Circuits) from secured creditors to debtors and other parties by denying secured creditors the presumptive right to credit bid in certain plan-based sales. These cases may encourage other bidders who might otherwise have opted not to bid against a secured creditor and will undoubtedly lead to disputes and a new body of decisions on what does and does not constitute indubitable equivalence. All of this appears to give debtors leverage to restructure and/or cram down secured debt.”²¹

“Secured creditors also may seek to fight back, for example, by restricting or conditioning the use of cash collateral or other assets to better protect their position. Anecdotal evidence from recent Chapter 11 cases suggests that sophisticated secured lenders are already seeking to do so in bankruptcy courts within the Third Circuit. Secured creditors may seek to force debtors to sell assets early in cases under a § 363 sale rather than waiting for the plan confirmation process because, although § 363 recognizes limitations on credit bidding “for cause,” the “for cause” limitation may be more difficult for a debtor to establish than establishing indubitable equivalence during plan confirmation. Also, these rulings may affect the distressed debt market well beyond the Fifth and Third Circuits in the ways Judge Ambro contemplated—by causing buyers of distressed secured debt to rethink pricing and exit options. Those who buy secured debt with a goal of acquiring the underlying assets or company should be particularly mindful of these added risks.”²²

“It is difficult to reconcile *Pacific Lumber* and *Philadelphia Newspapers* with the

21 Sam J. Alberts and David Lee Tayman, *Secured Lenders Do Not Have an Absolute Right to Credit Bid at Bankruptcy Plan*, 27 NO. 8 Bankr. Strategist 1 (June, 2010).

22 Sam J. Alberts and David Lee Tayman, *Secured Lenders Do Not Have an Absolute Right to Credit Bid at Bankruptcy Plan*, 27 NO. 8 Bankr. Strategist 1 (June, 2010).

Supreme Court's analysis in *Bank of America Nat. Trust and Sav. Ass'n v. 203 North LaSalle Street Partnership*, 526 U.S. 434, 119 S. Ct. 1411, 143 L. Ed. 2d 607, 34 Bankr. Ct. Dec. (CRR) 329, 41 Collier Bankr. Cas. 2d (MB) 526, Bankr. L. Rep. (CCH) P 77924 (1999), in which the court examined another means of confirming a plan over the objection of a secured creditor. The court reasoned (but did not expressly hold) that a plan confirmed under the 'new value' exception had to be tested through a process that produced a market valuation, rather than by a valuation established by a judge in a court. Under the readings of these two cases [*Philadelphia Newspapers* and *Pacific Lumber*], a debtor can sell the property free and clear as long as it pays the secured creditor what the court decides the collateral is worth, without subjecting the collateral to a market for valuation. This undercuts a fundamental protection on which secured creditors have, until now, been able to rely."²³

OTHER BANKRUPTCY RULINGS

Fifth Circuit (*In re Moore*)

Is a proposed settlement of bankruptcy estate claims a disposition of estate property under § 363?

Fifth Circuit, as a matter of first impression, holds that a proposed settlement of bankruptcy estate claims is a disposition of estate property under § 363. *In re Moore*, 608 F.3d 253, Bankr. L. Rep. P 81,781 (5th Cir.(Tex.) Jun 02, 2010).

A bankruptcy trustee may sell causes of action belonging to the estate. Section 363 of the Bankruptcy Code governs the sale, use, or lease of property of the estate, allowing the trustee to sell "property of the estate," other than in the ordinary course of business, after notice and a hearing. 11 U.S.C. § 363(b) (1). Section 541 defines "property of the estate" to include, among other things, "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(a)(1). "[T]he term 'all legal and equitable interests of the debtor in property' is all-encompassing and

²³ *Bankruptcy: Right to Credit Bid Limited*, 40-JUL Real Est. L. Rep. 7 (July 2010).

includes rights of action as bestowed by either federal or state law." A trustee may sell litigation claims that belong to the estate, as it can other estate property, pursuant to § 363(b). Whether a trustee's proposed compromise of estate claims can constitute a proposed sale of estate property that triggers § 363 sale provisions was an issue of first impression in the Fifth Circuit.²⁴ The cases are mixed [] on whether the settlement of a claim that the estate owns is a sale (that is, disposition) of property of the estate [citing *Hicks, Muse & Co., Inc. v. Brandt (In re Healthco Int'l Inc.)*, 136 F.3d 45 (1st Cir.1998) (deciding that settlement is not a sale), *Goodwin v. Mickey Thompson Entm't Group, Inc. (In re Mickey Thompson Entm't Group, Inc.)*, 292 B.R. 415 (9th Cir. BAP 2003) (stating that settlement is a sale); *In re Dow Corning Corp.*, 198 B.R. 214 (Bankr.E.D.Mich.1996) (same)]. The point may be academic for purposes of whether court approval is required, because Rule 9019 requires notice and a hearing and court approval of settlements, independent of section 363(b)(1). However, there may be other consequences, such as ... whether overbids are permitted. [citing *Mickey Thompson*].²⁵ Courts in the Third, Sixth, and Seventh Circuits, in addition to the *Mickey Thompson* court, have taken the position that a settlement may trigger § 363 requirements.²⁶ The Fifth Circuit adopted the reasoning of *Mickey Thompson*.²⁷ The proposed compromise in this case was a disposition of estate property. The creditor's higher offer obligated the bankruptcy court to consider whether an auction and § 363 sale were appropriate. Whether to impose formal sale procedures is ultimately a matter of discretion that the Fifth Circuit left to bankruptcy courts.²⁸

Research References: Bankruptcy Service, L. Ed. §§ 20:89, 20:110, 20:150, 20:175, 20:430, 20:431; Norton Bankr. L. & Prac. 3d §§ 44:2, 77:12; Norton Bankr. L. & Prac. 3d 11 U.S.C. § 363 Bankruptcy Law Manual 5d § 10:13.

²⁴ 608 F.3d 253 at 263.

²⁵ 3 COLLIER ON BANKRUPTCY, ¶ 363.02[1] [f] (15th ed. rev.2009); 608 F.3d 253 at 263.

²⁶ 608 F.3d 253 at 264 (citing cases).

²⁷ 608 F.3d 253 at 264.

²⁸ 608 F.3d 253 at 264.

Ninth Circuit (*In re Ormsby*)

Does a prior state court judgment in which debtor is found to have converted confidential business information preclude debtor from arguing against the application of § 523(a)(4) or (6)?

Ninth Circuit holds that a prior state court judgment in which debtor is found to have converted confidential business information precludes debtor from arguing against the application of § 523(a)(4) or (6) (2010). *In re Ormsby*, 591 F.3d 1199, 52 Bankr. Ct.Dec. 158, Bankr. L. Rep. P 81,663, 10 Cal. Daily Op. Serv. 313, 2010 Daily Journal D.A.R. 408 (9th Cir.(Cal.) Jan 08, 2010) (NO. 08-15572, 08-15573).

Section 523(a)(4) prevents discharge "for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny." 11 U.S.C. § 523(a)(4). "For purposes of section 523(a)(4), a bankruptcy court is not bound by the state law definition of larceny but, rather, may follow federal common law, which defines larceny as a 'felonious taking of another's personal property with intent to convert it or deprive the owner of the same.'" 4 Collier on Bankruptcy ¶ 523.10[2] (15th ed. rev. 2008). The Debtor Ormsby's main contention was that the facts of the state court judgment do not prove larceny for the application of section 523(a)(4) because the federal definition of larceny requires fraudulent intent whereas conversion under Nevada state law does not require a finding of fraudulent intent. Conversion is defined as "a distinct act of dominion wrongfully exerted over another's personal property in denial of, or inconsistent with his title or rights therein or in derogation, exclusion, or defiance of such title or rights. Additionally, conversion is an act of general intent, which does not require wrongful intent and is not excused by care, good faith, or lack of knowledge." *M.C. Multi-Family Development, L.L.C. v. Crestdale Assoc., Ltd.*, 193 P.3d 536, 542-43 (Nev.2008) (internal citations omitted). Accordingly, Ormsby argued that the state court's finding of conversion does not translate to a finding of larceny; therefore, the issue is not precluded.

The Ninth Circuit made no determination concerning whether federal law requires a finding of fraudulent intent for larceny as Ormsby contended: “Were we to find that larceny required fraudulent intent, the state court judgment would provide enough information to determine that the court found that his actions amounted to fraud, because ‘[i]ntent may properly be inferred from the totality of the circumstances and the conduct of the person accused.’ Kaye v. Rose (In re Rose), 934 F.2d 901, 904 (7th Cir.1991). The totality of the circumstances as described in the state court’s findings of fact made clear that Ormsby acted with fraudulent intent. When he started Inter-County, he purchased the rights to use the title plant for 2000 until the present, demonstrating that he was aware of the lawful means of obtaining access to them. Rather than purchasing the rights to the title plants for the 1900s, he hired McCaffrey away from a competing title company and discussed with him the importance of the title plants to a new title company. While McCaffrey still had access to the plants that First American Title Co. (“FATCO”) possessed, Ormsby encouraged, cooperated, and assisted McCaffrey’s removal of the plants and their reproduction. Of particular note, Ormsby sent the microfiche containing the plants to a non-local copying service, likely to avoid detection. Based on these facts found by the state court, Ormsby’s conduct constituted larceny within the federal meaning of the term; accordingly under section 523(a)(4), his debt cannot be discharged.”²⁹

Section 523(a)(6) prevents discharge “for willful and malicious injury by the debtor to another entity or to the property of another entity.” 11 U.S.C. § 523(a)(6). The Supreme Court in *Kawaauhau v. Geiger* (In re *Geiger*), 523 U.S. 57, 118 S.Ct. 974, 140 L.Ed.2d 90 (1998), made clear that for section 523(a)(6) to apply, the actor must intend the consequences of the act, not simply the act itself. *Id.* at 60, 118 S.Ct. 974. Both willfulness and maliciousness must be proven to block discharge under section 523(a)(6). The Court held on the facts that under § 523(a)(6), the willful and malicious injury

requirement is met when the debtor believes that injury is substantially certain to result from his conduct and this was applicable in this case.

First Circuit (In re Sherman)

Is there a “Robin Hood” defense to a § 523(a)(4) exception to discharge based on embezzlement?

First Circuit holds that there is no “Robin Hood” defense to a § 523(a)(4) exception to discharge based on embezzlement. In re Sherman, 603 F.3d 11, Bankr. L. Rep. P 81,743 (1st Cir. (Mass.) Apr 21, 2010) (NO. 09-1572).

Section 11 U.S.C. § 523(a)(4), exempts from discharge any obligation resulting from the debtor’s “embezzlement”. A Chapter 7 debtor’s participation in the unauthorized conversion of a creditor’s assets, by rebilling disastrous investments to the creditor’s liquid accounts to cover a shortfall at an investment firm, was committed with the debtor’s fraudulent intent based on his knowledge that use of the entrusted assets was unauthorized by the creditor. The move rescued the three investors and kept the firm’s doors open for a time but cost the appellees nearly \$983,000. The Court noted that there is no definition of embezzlement in § 523 or elsewhere in the Bankruptcy Code, and they assumed that Congress wrote with the common law in mind, *Neder v. United States*, 527 U.S. 1, 23, 119 S.Ct. 1827, 144 L.Ed.2d 35 (1999), and *United States v. Young*, 955 F.2d 99 (1st Cir.1992), will suffice for an explanation of the traditional elements of embezzlement. Embezzlement is “the fraudulent conversion of the property of another by one who is already in lawful possession of it.” *Id.* at 102 (internal quotation marks omitted). Thus, to amount to embezzlement, conversion must be committed by a perpetrator with fraudulent intent, and the question is whether the bankruptcy court found it on the debtor Sherman’s part. *Young* is helpful in its example of embezzlement by using entrusted money for the recipient’s own purposes in a way he knows the entrustor did not intend or authorize. *Id.* It is knowledge that the use is devoid of authorization, scienter for short, see *Palmacci v. Umpierrez*, 121 F.3d 781, 786 (1st Cir.1997), that makes the conversion

fraudulent and thus embezzlement, and it is just this knowledge that the bankruptcy court found that Sherman had as a participant in the conversion. The judge found that the principals at the Whitehorne office were aware of the problem and of the expedient Dunn proposed. Their positions in the company necessarily gave them power over its actions, and there is no evidence that debtor Sherman objected or distanced himself in any way from the course of action proposed and taken in the firm’s name; the district court fairly characterized these facts as showing that Sherman was “directly involved” in the rebilling.. The Court stated that there is no “Robin Hood” defense that excuses defendants who misuse the entrusted property of the solvent in order to save the company.

First Circuit (In re Pellegrino)

Can Chapter 13 debtors with negative monthly income satisfy the “regular income” requirement of § 109(e) by making a one-time payment to creditors that is funded by a friend?

First Circuit BAP holds that Chapter 13 debtors with negative monthly income cannot satisfy the “regular income” requirement of § 109(e) by making a one-time payment to creditors that is funded by a friend. In re Pellegrino, 423 B.R. 586, Bankr. L. Rep. P 81,689 (1st Cir.BAP (R.I.) Feb 09, 2010) (NO. RI 09-042, 09-11535-ANV).

Chapter 13 is available to an “individual with regular income,”³⁰ which is defined as an “individual whose income is sufficiently stable and regular to enable such individual to make payments under a plan under Chapter 13 of this title,” 11 U.S.C.A. § 101(30). Courts have recognized that Congress intended a liberal interpretation of “regular income.” See In re Ellenburg, 89 B.R. 258, 260, 48 Ed. Law Rep. 844 (Bankr. N.D. Ga. 1988); In re Cohen, 13 B.R. 350, 356 (Bankr. E.D. N.Y. 1981) (disapproved of by, In re Rowe, 110 B.R. 712 (Bankr. E.D. Pa. 1990)). The test for regular income is not the type or source of income, but rather its regularity and stability. In re Varian,

³⁰ See Who is “individual with regular income” eligible to be Chapter 13 debtor under §§ 101(30) and 109(e) of Bankruptcy Code of 1978 (11 U.S.C.A. §§ 101(30), 109(e)), 161 A.L.R. Fed. 127.

91 B.R. 653, 654 (Bankr. D. Conn. 1988); *In re Campbell*, 38 B.R. 193, 195 (Bankr. E.D. N.Y. 1984).

Generally, certain nontraditional income sources can qualify as sufficiently regular and stable to support a plan. See, e.g., *In re Hammonds*, 729 F.2d 1391, 1393 (11th Cir. 1984) (finding that AFDC payments constitute regular income); *Matter of Cole*, 3 B.R. 346, 348-349 (Bankr. S.D. W. Va. 1980) (holding that odd jobs such as carpentry and “junkin” are regular income). Further, contributions from family members may amount to regular income. See, e.g., *In re Rowe*, 110 B.R. 712, 717-718 (Bankr. E.D. Pa. 1990) (determining that payments from son were stable and regular). But see *In re Cregut*, 69 B.R. 21, 22-23 (Bankr. D. Ariz. 1986) (characterizing monthly payments from father to son as gifts and not income); *In re Campbell*, 38 B.R. at 196 (providing that gratuitous payments from family members generally are not income unless unique circumstances exist); *In re Ross*, 173 B.R. 943, 945 (Bankr. E.D. Okla. 1994) (Income dependent upon discretion is not regular income). Many decisions have also addressed whether income from a spouse constitutes regular income. An unemployed spouse may rely on a codebtor’s income to fund a plan. See, e.g., *In re McLeroy*, 106 B.R. 147, 148-149 (Bankr. W.D. Tenn. 1989) (noting that language of § 109(e) clearly allows such). Further, an employed spouse has been allowed to supplant his or her income with income of a nondebtor spouse. See, e.g., *In re Ellenburg*, 89 B.R. at 260 (allowing debtor who received \$500 per month from husband for bookkeeping services to file a plan); *In re Cohen*, 13 B.R. at 356-357 (determining that a salesman could help fund spouse’s plan who worked as a secretary). An individual who was employed and had regular income could file a Chapter 13 in her capacity as trustee of real estate trust, even though no income was derived from the trust. *Federal Home Loan Mortg. Corp. v. Wynn*, 29 B.R. 679 (Bankr. D. N.J. 1983).

In this case The Trustee posited that a debtor with negative monthly income

could satisfy the “regular income” requirement only if a family member were to pledge to make up the shortfall for the life of the plan, and concluded that: “[t]he language of the statute says there’s supposed to be a plan, there are supposed to be payments under a plan, and this one-shot deal doesn’t do it.” The Debtors conceded that they would have a monthly shortfall, even with their friend’s contribution, but asserted that their proposed lump sum payment to creditors means that they alone bear the risk that their income may not improve.³¹

The bankruptcy court took the matter under submission, and subsequently issued the Dismissal Order. In dismissing the Debtors’ case, the court concluded that the Debtors do not have excess income from which to make plan payments and are therefore not eligible for chapter 13 relief.³² The First Circuit Court affirmed the holding.

Fifth Circuit (*In re TransTexas Gas Corp.*)
Under § 548 is it enough to prove that defendant was an insider at the time an obligation is incurred even where defendant was not an insider at the time that payments are made?

Fifth Circuit holds that under § 548 it is enough to prove that defendant was an insider at the time an obligation is incurred even where defendant was not an insider at the time that payments are made. *In re TransTexas Gas Corp.*, 597 F.3d 298 at 305; Bankr. L. Rep. P 81,684 (5th Cir.(Tex.) Feb 10, 2010) (NO. 08-20401, 08-41128).

TransTexas entered into a three-year employment contract with its founder, CEO, and chairman of the board of directors, John Stanley (“Stanley”). The employment contract provided that in the event of termination, Stanley would be entitled to \$3 million if the termination was without cause and \$1.5 million in the event the termination occurred with cause. If Stanley voluntarily left, he would receive no severance. Less than one year prior to debtor’s bankruptcy, debtor’s board of directors decided to terminate Stanley. After this meeting, Stanley entered into discussions with debtor’s board

³¹ 423 B.R. 586, 589.

³² 423 B.R. 586, 589.

of directors and executed a separation agreement that expressly superceded the employment contract and provided Stanley a severance payment of \$3 million upon his resignation as CEO and director. Three months after Stanley’s termination, the debtor filed its bankruptcy. When determining if Stanley was an insider, the court held that pursuant to Section 548, “there is no textual limitation of insider status to the time in which the transfer is made” and for the purposes of Section 548 “it was “enough” that Stanley was indisputably an insider at the time he entered into the relevant obligation.” ■

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Business in Crisis: Stabilization and the End Is Near

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In the article, “*Business in Crisis: After Week One*,” the focus of a business in crisis is on maintaining operating capability, and developing a near-term plan and a cash flow forecast (typically 13 weeks out) reflecting conditions and support agreed to by the stakeholders. It is critical at this time to have a plan and funding in place so the Company can continue to operate while developing a long-term solution.

The major milestones triggering the transition from “After Week One” activities are:

- Continuing to stabilize operations
- Completing a 13-week cash flow forecast acceptable to key stakeholders
- Agreeing on near-term funding support: operating cash flow and use of cash collateral (bank continues to lend), customer support (payable terms shortened, price increases, material purchases, etc.), asset disposition, lender forbearance, and others
- Managing stakeholder interests, maintaining stand-still arrangements and assessing the need for protection under the Bankruptcy Code

The breathing room obtained by completing the above activities allows the Company and its professionals, legal counsel and turnaround specialists to focus on the following:

- Long-term viability assessment that is aligned and consistent with stakeholders’ long-term interests
- Financial forecasting and analysis for one to three years forward based on viability and stakeholder assessments
- Strategy development and negotiation of critical concessions and commitments from stakeholders to support the selected strategy: going concern (viability), sale, or wind-down and liquidation of operations
- Strategy implementation

Viability and Stakeholder Assessments

As described in “After Week One,” the most critical factor in determining the long-term strategy for a business in crisis is its future viability. If a business is clearly not viable, then the decision can be made early-on to wind down and liquidate.

It takes time to analyze the profit potential of the various components of the business, which requires identification of the profitable and unprofitable products, customers, and segments, as well as possible cost reductions or revenue-enhancement opportunities. Many other factors may need to be considered to determine if the business is viable, including: assessments of potential asset or segment

dispositions; customer demand and commitment to not resource the business; employee cooperation and support of needed changes; the ability to obtain long-term funding.

Understanding the true needs and leverage the stakeholders have is an on-going process. As stakeholders become more knowledgeable about the Company’s viability as well as the risks and impact of the current situation on their interests, their needs and interests will most likely change.

The viability assessment and the stakeholder assessment are co-dependent and iterative processes. A long-term viability assessment is needed for the stakeholders to assess their alternatives, positions and willingness to support the plan. Before a long-term strategy can be defined, the Company must demonstrate that it is viable and has the necessary support from its stakeholders.

Financial Forecasting and Analysis

A realistic, achievable, and detailed bottom-up financial forecast—including monthly income statements, balance sheets, cash flow statements with supporting schedules—needs to be prepared.

A thorough analysis using activity-based costing will enable better understanding of the profitability of business segments, products, customers and locations/regions. The sales forecast should be based on current trends, adjusted conservatively for known (or high probability) changes or improvements. Cost improvements should be thoroughly vetted and supported by a measurable and achievable action plan before being included in the forecast. Forecast assumptions should be clearly identified and the financial model should be dynamic to easily accommodate changes in assumptions and “what if” scenarios. The assumptions and forecast must be believable and credible in order for stakeholders to commit to supporting the Company.

The forecast provides the basis for stakeholder commitments, obtaining funding (interim and long-term), and strategy development and acceptance. In the end, a decision has to be made as to whether the company can be restructured either in or out of bankruptcy, sold in whole or in part, or liquidated.

Strategy Development and Stakeholder Negotiation

Based on the stakeholder and viability assessments, strategies (including alternatives) need to be identified. If the Company can reasonably demonstrate its viability and stakeholders are cooperative and supportive, the primary strategy may be to restructure (in or out of bankruptcy). In this case, existing management and possibly equity ownership could remain in place. However, if stakeholders lack confidence in the existing management team, or are unwilling to support the

prior management or ownership, the stakeholders may only support the Company if it is sold to an acceptable buyer. The stakeholders may also require a sale if the viability assessment is marginal and the Company could benefit from synergies or the financial or strategic strength of a purchaser.

Many times, Companies will go down parallel paths and pursue more than one strategy. For instance, the Company may want to restructure on its own while concurrently preparing for a sale process should it be unable to obtain the financing needed for a restructuring.

If the Company cannot demonstrate it is viable after restructuring, it needs to assess whether the Company, or parts of the Company, could be sold as a going concern for an amount in excess of liquidation value. When the Company is at the point of having to sell or liquidate, it has a fiduciary responsibility to maximize the value of the “estate” for the benefit of its creditors. This is true whether the sale or liquidation is conducted in or out of bankruptcy. Legal counsel should be consulted when any sale or liquidation transaction is contemplated to ensure that the transaction is done properly and in accordance with the secured or unsecured creditors’ rights.

If the Company is unable to sell as a going concern, the assets must be liquidated. The stakeholders need to determine what type of wind-down is required and for how long, and how it will be funded. In just-in-time manufacturing, customers usually need a wind-down period to

build a bank of parts to allow time for moving production to a new source. In this case, the customers may fund the wind-down period to protect production. In a retail environment the Company can cease operations and liquidate without a significant or costly wind-down of operations. In this case, the creditors would probably fund the wind-down to maximize liquidation value.

Following is a chart summarizing some key considerations that stakeholders may assess to determine their preferred strategy and the degree of support they are willing to provide.

During this period, assessments should be made regarding the need to file for protection under the Bankruptcy Code, as bankruptcy may become necessary to preserve the value of the estate and/or return to viability. Factors that influence this decision include:

- Are creditors uncooperative and unwilling to stand still?
- Are there significant executory contracts that need to be rejected?
- Do significant debts exist that need to be restructured?
- Are there outstanding litigation issues or liens on assets?

| BUSINESS IN CRISIS STAKEHOLDER CRITERIA FOR STRATEGY SUPPORT | | | |
|---|---------------|--------|--------------|
| STAKEHOLDER / CRITERIA | ASSESSMENT | | |
| Secured Creditors | | | |
| Secured Position | Under secured | | Over secured |
| Capability / Integrity of Management | Low | | High |
| Ability to Meet Future Debt Obligations | Low | | High |
| Concessions Required | Low | | High |
| Unsecured Creditors | | | |
| Volume and Profitability of Business with Company | Low | | High |
| Probability and Magnitude of Repayment | Low | | High |
| Capability / Integrity of Management | Low | | High |
| Employees | | | |
| Current and Expected Employment Market | Poor | | Good |
| Union Support | Low | | High |
| Capability / Integrity of Management | Low | | High |
| Shareholders | | | |
| Recovery of Investment | Low | | High |
| Customers | | | |
| Capability / Integrity of Management | Low | | High |
| Price, Quality and Delivery Performance | Poor | | Good |
| Ability to Resource to New Supplier | Easy | | Difficult |
| Degree of Support | Low | Medium | High |
| Probable Outcome | Liquidation | Sale | Restructure |

During this period of a business in crisis, one of the most difficult challenges for the Company, legal counsel and turnaround professionals is aligning the stakeholders around the preferred strategy and negotiating and documenting a comprehensive set of agreements supporting the strategy and commitments required.

Strategy Implementation

Once the strategy is determined, the agreements are documented and executed, and the forecast reflects the strategy and the terms, an action plan must be developed and implemented.

Planning consideration must be given to various issues including:

What are the sources, timing and amount of funding required?

- What distributions will be made to stakeholders, if any? From what proceeds?
- How will the Company be sold? Have minimum values been determined that are deemed acceptable to the stakeholders? Will an investment banker be retained and if so, which one?
- In a wind down, how long will operations need to continue? What size part bank is required? How will the parts bank be packaged and stored? How will employees be incentivized to stay through the wind-down period?
- If assets are to be liquidated, will an auction be conducted? If so, who, when and under what terms? In what condition will the facilities need to be upon exit? Are there environmental issues to resolve?
- Which employees will remain and for how long? Is a WARN Act notice required?

In addition to the above, there are other planning considerations based on the strategy and agreements in place. Reporting to the stakeholders will continue and, if filing for bankruptcy is part of the strategy, additional reporting and legal processes will need to be incorporated into the plan.

If the strategy does not require filing for bankruptcy, care needs to be taken to maximize value for the creditors, and distributions (if made) need to be in accordance with the agreements. Those managing and executing the plan must fulfill their fiduciary responsibilities to all of the various stakeholders.

Summary

The time period after “week one” in a business crisis is very demanding. While still dealing with multiple short-term issues, the focus needs to be expanded towards the mid-term or next 13-week period. At the end of “week one” the Company will have a short window (2-4 weeks) to develop a strategy and gain stakeholder acceptance necessary for the Company to survive through the mid-term (approximately a 13-week period).

The mid-term period allows time for the Company and its professionals to identify the longer term alternatives that may be possible given the initial financial, stakeholder and viability assessments. During this period, it is critical to improve the trust and credibility between the Company and its stakeholders. The stakeholders must be confident that the situation is being handled by the Company and its professionals in an efficient, forthright and equitable manner.

Finally, as the title of this article suggests, “The End Is Near”—one way or another. A direction will be taken that either preserves some or all of the business as a viable going concern, or the assets will be liquidated. Getting to an end, while maximizing value to the stakeholders given their claims, priorities and interests, requires patience and tenacity on the part of those responsible for managing and concluding the business in crisis process. Choosing an experienced team to guide the process is critical to maximization of value, appropriate treatment of stakeholders and success of the workout.

Scott Smith, CIRA, CTP

Scott is a Senior Director at HYDRA Professionals, LLC. He has more than 30 years of diverse business experience. For the past 15 years he has provided financial turnaround consulting for many businesses representing various stakeholders. Prior to consulting,

Scott was the Controller for an automotive engineering and manufacturing company. Scott has developed and delivered financial and program management training programs to businesses and instructed cost and managerial accounting at Oakland University. Scott Smith may be contacted at (248) 766-0885 or by e-mail at ssmith@hydrapro.com.

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Part 2: October 20-22, 2010

Malibu, CA

Part 1: October 25-27, 2010

Chicago, IL

Part 2: November 8-10, 2010

Ft. Lauderdale, FL

Part 1: November 17-19, 2010

New York, NY

Part 3: December 8-10, 2010

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Part 2: January 19-21, 2011

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Part 3: February 7-9, 2011

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