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Preventing Family Business Failures

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The survival of financially challenged family-held businesses is a critical factor in the current economic environment. Family-held concerns represent 80-90 percent of U.S. businesses in number, 64 percent of the nation's gross domestic product, and 62 percent of employment in the U.S. work force, as recently reported by *Family Business Review*. Improving the survival rate of family-held businesses has significant potential to positively impact economic recovery and constitutes a substantial part of the work performed by insolvency and restructuring professionals.

Turning around a failing family business today requires dealing with a set of challenges that are both similar to and different from those facing other businesses. This issue was recently addressed at TMA's annual convention and in my contribution to a panel discussion on strategies to help family businesses survive. The greatest difficulties for family businesses are not taking action early enough to avoid a crisis, intergenerational transfer issues and limited new financing options.

Family businesses usually do not seek help early on when they start to trend negatively because they are unaccustomed to hiring consultants and believe they cannot afford them. The failure to hire consultants is associated with and compounded by frequently observed patterns of inadequate planning and failure to identify emerging trends and future risks.

When consultants are called in after the family business is already experiencing distress, they often find the original business model that was successful in early years is still in force even though the market has evolved beyond it. Too often the owner is so busy working in the business that he or she has not taken the time to do the planning needed to mitigate emerging risks and capitalize on new opportunities.

Without planning, family-held businesses over time often become unprofitable for the following reasons among others:

- Customer needs have changed and the business has not addressed this.
- The business has not responded effectively to its competitors.
- The Internet's impact on price shopping and product availability has not been addressed.
- The business has not prepared for economic downturns.
- Poor investments in unprofitable facilities and/or products have not been dealt with.

Intergenerational transfer of management presents the second area of particular difficulty for family businesses. There is a 70 percent business failure rate among second-generation family business owners and an 88 percent failure rate for third-generation owners, according to *Family Business Review*. This occurs primarily when the founder's descendants are assigned roles in which they do not have the required skills or strengths to be effective. Too often it is erroneously assumed the second generation has the same strengths, motivation and skills as the first generation. Understanding the strong points of the second-generation family members and then finding roles for them that leverage their distinct abilities is critical. The right people in the right roles are needed going forward in order for any business to be successful, which is especially important in family businesses where there may be little margin for error. It is often the case that second-generation family members are put in roles where their strengths are not well aligned with the needs of the company and their inability to perform well contributes to its demise.

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Letter from the President

Stephen Darr, CIRA, CDBV
Mesirow Financial Consulting LLC

Dear Members:

As I write this, many terrific things have happened within our organization recently and many more are planned for the next few months. Some of our recent programs included:

- Our 10th Annual Advanced Restructuring and Plan of Reorganization Conference was held in New York City on November 14, 2011. One highlight was that Judge Rosemary Gambardella received our Judicial Excellence Award.
- AIRA's Expert Witness Advanced Training Program: Phase 1, developed by Professor Jack Williams, our scholar-in residence, was held in Atlanta on November 15- 17.
- The 8th Annual Corporate Restructuring Competition was held at the Wharton Business School on November 5, 2011.

If the short days of winter are giving you SAD (Seasonal Affective Disorder), there's no better cure than participating in an upcoming AIRA Program or Committee. The following programs are scheduled in the near future:

- 7th Annual New York Institute of Credit/AIRA Joint Bankruptcy & Restructuring Event will be held on Wednesday, January 25, 2012 in New York City. Some of the issues to be covered include Achieving Prompt and Efficient Confirmations: Pre-Negotiated Plans, Pre-Packaged Plans and Plan Support Agreements; an all-star cast of panelists will be featured.
- VALCON 2012 will be held in Las Vegas on February 22-24. This conference on valuation is jointly presented by AIRA, ABI and the University of Texas at Austin Law School. Some of the topics to be covered include the latest valuation issues and financial market developments; another all-star group of panelists is promised.

Another way to beat the "winter blues" may be to join a committee to plan future activities or address emerging issues. Right now, committee slots are available for:

- AIRA's 28th Annual Bankruptcy & Restructuring Conference, which will be held in San Francisco on June 6-9 2012.
- Committee to address the proposed revised *Attorney Fee Guidelines* recently issued by the Office of the United States Trustee (revised guidelines for other professionals are forthcoming).
- Committee to address the emerging migration to International Financial Reporting Standards.

Finally, you could write an article for *AIRA Journal*; new submissions will be considered until mid-January for the next publication date. Please contact me or Grant Newton if you would like to participate in these or other activities. I guarantee it will make the winter go faster.

Steve Darr

Family Business Failures continued from p. 1

Limited financing options constitute the third major obstacle confronting family businesses dealing with distress. Many banks today are actively seeking to issue loans to credit-worthy business customers; however, to be attractive to a lender, the business must be of a certain size. Most family-held businesses fall into the small or lower middle market categories with annual sales of $10 million or less and unfortunately the number of banks lending to this sector is small. If the struggling family business is being asked by its current lender to transfer its loan to another lender, options will most likely be quite limited.

What are the most important actions turnaround professionals can take to help troubled family businesses survive? The first step is to get involved before trouble starts. There are a number of services consultants can provide to businesses while they are still healthy that are designed to keep them financially viable. Turnaround professionals and financial advisors can help family businesses improve their planning function and provide guidance for corporate renewal and performance improvement. For example, a simple one- or two-day planning project with a client to identify threats, risks, and opportunities can help create an action plan to deal proactively with challenges, avert problems and go a long way toward safeguarding the future of the business.

Another way in which financial consultants can assist struggling family-held businesses is by turning the focus from the process of sustaining or turning around the existing business to the process of sustaining wealth. Habbershon and Pistrue noted that "Families committed to transgenerational wealth must understand that markets inevitably change and that all asset-dependent advantages erode over time." [1] Focus on transgenerational wealth requires the family ownership group to develop entrepreneurial change capabilities and to recognize the need to shed or reassign assets once value-creating properties begin to deteriorate.[2]

Another important function a turnaround professional may perform is to assist with management of family dynamics threatening the future of the business. As independent third parties, consultants are in a position to offer unbiased perspectives on these issues. Many times through the implementation of goals, objectives, and improved accountability, performance issues involving certain family members become evident and can be addressed. It has been the author's experience that working through the company's CPA or bank for a client introduction can positively impact service to the potential client. These referral sources have an interest in keeping clients viable and are usually willing to make an introduction to their customers as long as needed services can be delivered on a cost effective basis.

Family business advisors may find it helpful to refer to the comprehensive study by Nason, Nordqvist, and Zellweger[3] based on responses to an online questionnaire circulated to senior family firm executives. The average annual revenue of the population in the study ranged from less than $1 million to $3 million USD and average enterprise age was 60 years, ranging from 20 to 384 years. The results of the study help provide a clearer picture of the dynamics of family-founded business and challenge some traditional assumptions:

- 10.6% of the family enterprises owned only one business.
- The average number of companies controlled was 3.4.
- 21.3% of the families controlled five or more businesses.
- Over of the history of the participating families, an average of 6.1 firms had been owned, with an average of 2.7 firms acquired by acquisition.
- Over the families' history, they had spun off an average of 1.5 businesses.
- Nearly 90% of the families in the study population own multiple businesses; the end of one business does not end a family's wealth-creating activity; successful families have business failure as well as success in their history.
- Over the history of the families' business activities, their main industry shifted an average of 2.1 times.

During the current environment of continuing economic weakness, there are many obstacles to survival of distressed family businesses including lack of early intervention, problems with intergenerational transfer and limited financing opportunities. Although credit markets will continue to be problematic in the near term, financial and operational consultants can provide critical services through early intervention and planning, focus on sustaining wealth, and assistance with managing intergenerational transfer and change. Because of the significant role played by family-held businesses, finding ways to reduce risk of failure will ultimately protect jobs and strengthen the U.S. economy. ■

Mr. Downes is a Senior Director with BBK in their Los Angeles Office. A Certified Turnaround Professional, he has over 23 years of experience, specializing in the technology, manufacturing and retail industries. His experience includes working with limited funds and raising capital, as well as international expansion into Europe and Asia.

1 Timothy G. Habbershon and Joseph Pistrui. *Family Business Review*, 15[3]: 223-38, 2002.

2 *Ibid*.

3 Barbara Spector. Family business longevity examined in new light. *Family Business Magazine.* (2011). http://www.familybusinessmagazine.com/index.php?/freefeature

Executive Director's Column

Grant Newton, CIRA
AIRA Executive Director

Dear Members,

As we approach the end of another year, I want to think all of you for the support that you have provided to AIRA over the last 12 months. The Association began its 28th year in October and we are looking forward to many edifying and enjoyable events in 2012. Registration is or will be available online at www.AIRA.org—I am certain you will find numerous benefits from each one you are able to attend.

January 10, Webinar—Receivership Part 1: Basics (Part 1 of a 3-part series). The first session in this series is being organized and moderated by Chip Hoebeke, Senior Manager with Rehmann (a different moderator will serve for each part). Topics of Part 1 include What is Receivership/Receivership Authority? Practice guide/steps for 1st day in receivership; Where can receivers reach out for resources?

January 25, AIRA/NYIC Joint Restructuring Event (Arno Ristorante, New York NY). **SESSION I:** 2012 Forecast: Industries Most Likely to Have Bankruptcies & Reorganizations. **SESSION II:** Achieving Prompt and Efficient Confirmations: Pre-Negotiated Plans, Pre-Packaged Plans and Plan Support Agreements

February 16, Webinar—Ch. 9 / Municipal Bankruptcy Part 1 (Part 1 of a series; other dates TBA). This session is moderated by Kenji Mochizuki, CIRA, Valuation Section Editor of *AIRA Journal*. Topics include Ch. 9, governmental accounting and budgeting, public finance, municipal bonds and defaults, municipal bondholders' rights and remedies, bond restructurings, municipal workout process.

February 22-24, VALCON 2012 (Four Seasons Hotel, Las Vegas). Join leading restructuring and valuation experts, attorneys, private equity investors, bankers, financial advisors and workout specialists to network and discuss cutting-edge valuation issues and market developments. Up to 15 hours CPE/CLE Credit including 1.00 hour of Ethics. Major sponsors: **Duff & Phelps, FTI Consulting, Mesirow Financial,** and **Skadden**

March 8, Webinar—Receivership Part 2: How to Operate a Receivership

May 15, Webinar—Receivership Part 3: Special Circumstance Receiverships

June 6-9, 28th Annual Bankruptcy & Restructuring Conference (Grand Hyatt San Francisco). Industry experts convene to discuss current topics in bankruptcy, taxation, insolvency and restructuring. Earn CPE and CLE credit including 1.00 hours of ethics. Great social events planned in the vibrant city of San Francisco.

October 24-27, 86th Annual National Conference of Bankruptcy Judges (San Diego CA). AIRA will again host the opening reception and sponsor the Friday breakfast program at this renowned industry event.

November (date TBA), 11th Annual Advanced Restructuring and Plan of Reorganization Conference (New York NY). This annual event puts a spotlight on current developments, industries to watch, and litigation relevant to the industry.

I wish you the best in 2012 and hope to see you soon
at one of AIRA's events,

Grant Newton

Scholar in Residence

Professor Jack F. Williams, CIRA, CDBV
AIRA Scholar in Residence
- Georgia State University College of Law
- Mesirow Financial Consulting, LLC

Bankruptcy Retakes

TEACHING EXPERTS BY SIMULATIONS

Recently, the AIRA conducted its inaugural expert witness workshop in Atlanta, Georgia. Ten participants joined together in Atlanta with three instructors and three guest speakers over three days of intense instruction and simulation. Part I of the Advanced Expert Witness Workshop focused on the engagement, ethics, and report writing process. Each participant was invited to provide a sample expert report for a personal critique.

During the first day, instructors led the students through the engagement process, critiquing various clauses in a retention or engagement agreement. Common pitfalls regarding scope, responsibility, and fees were addressed. Participants heard from attorneys and financial advisors on the topic, a common approach used throughout the workshop.

The instructors introduced ethics issues and guidance throughout the retention and writing stages of being an expert witness. A number of common hazards were discussed with suggestions on how to avoid or mitigate those problems.

The first day continued with discussions on the expert in discovery, expert qualifications, the *Daubert* requirements of relevance and reliability, consulting and testifying roles, the structure of expert reports, the art of the rebuttal report, and amending a report. The first day concluded with a working dinner where a faculty member introduced the class to the simulation that would follow them for the next two days and would be the topic of their reports.

The second day focused on writing reports; common mistakes in writing were identified and suggestions offered. Excerpts from numerous reports were examined, weaknesses or mistakes identified and addressed, and suggestions for replacement language and analysis offered. Participants were divided into two groups and tasked with preparing an expert report on the topic discussed the previous evening. Report outlines were developed and shared between the two groups. Faculty moved between the two groups to provide advice and suggestions. The second evening ended with a frank and insightful discussion with a retired bankruptcy judge who provided entertaining remarks about the judge's view of experts, the proper role, tips, and missteps to avoid in assisting the court.

The final day turned to actual report writing. Each group assigned sections of the report among its members and the various section write-ups were integrated into a report. Each report was then shared and critiqued by faculty and the other team. During the writing phase, individual conferences between participants and faculty took place wherein previously provided expert reports were reviewed and suggestions were shared.

In all the simulation approach appeared to be a big success. Evaluations were very positive and the faculty received thorough and constructive feedback. Phase II is already in the works; in it, participants will be walked through the expert witness process as it moves into the deposition and then trial stages. The previous expert report will be used as the centerpiece for numerous simulations in both a deposition and trial setting. We hope to see you in either Phase I or Phase II soon.

Personally, I want to thank the participants, faculty, and guest speakers who made the inaugural program a big success. I also want to thank my colleagues at Mesirow Financial who supported this program by loaning their education center in Atlanta, and the AIRA personnel who helped with the logistics of this new program. Finally, I thank my assistant, Juli Eggleston, for her wonderful work in ensuring an enjoyable experience for all. ■

Questions and comments may be sent to Professor Williams at jwilliams@mesirowfinancial.com.

Club 10

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

FTI Consulting, Inc.	**101**	**Mesirow Financial Consulting LLC**	**27**
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Huron Consulting Group LLC	**29**	**Office of the U.S. Trustee**	**10**
Grant Thornton LLP	**28**		

Rupert's Last Act?[1]

Eric A.W. Danner, CIRA
Partner
CRG Partners Group LLC

Despite being protected by what is perceived to be a lap dog board of directors, News Corp. will ultimately have to respond to the heat produced by the phone-hacking scandal by relieving Rupert Murdoch of his dual chairman of the board and CEO positions.

In July rumors surfaced that nine independent directors—out of 17 total—wanted to replace him in the CEO position with president and COO Chase Carey. Murdoch, who with his family controls a majority of voting shares of the company, blithely answered a question about his potential ousting on an earnings call: "I hope the job won't be open in the near future."

It is inevitable that Murdoch will be forced to offer a symbolic, in the least, resignation from both his chairman and CEO position. After all, holding both positions is poor corporate governance, affording few checks and balances on managerial behavior. Who does the dissident director or shareholder have the conversation with about the underperforming CEO? Lack of separation between church and state has never been a good idea, in any context.

If you look at the history of corporate boards, his stacking of the deck is not unusual. During the past two decades, however, boards have become more professional in their attitudes toward corporate governance. There's still a significant amount of cronyism on boards but less so than before. Today you're more likely to see a requirement in the corporate bylaws to have a certain number of directors who are independent.

The increased professionalism of boards has been driven in large part by the increased number of lawsuits against boards of directors. It used to be that companies would fail and there was no post-mortem analysis. Now, with public companies, there's likely to be a legal or forensic accounting analysis of what went wrong, especially if creditor constituencies are faced with the prospect of little or no financial recovery.

Creditors and investors want to know why they lost money and where to go to recover value, either from directors and officer liability insurance policies or the personal assets of management and directors.

Economic reality still challenges the idea of a truly independent director. Professional board sitting is a lucrative job for business people, and a director can make $75,000 for attending four board meetings a year. If you were to call out bad behavior by management or other board members, you could be jeopardizing your director's fee income. And if you become known as a perennially dissident board member with a track record of conflict with management, you may well become damaged goods as a professional board sitter.

Murdoch, 80, has said he has no plans to step down. Still, the pressure mounts. There are many investigations into reporters hacking their way into the phones of crime victims and celebrities, some of whom have filed their own lawsuits. Criminal investigations on both sides of the Atlantic have been reported.

And of course lawyers are lining up shareholders to sue News Corp. over mismanagement. *Adweek* reported that an older suit was recently amended to allege that widespread phone hacking by News of the World employees "should not have taken years to uncover and stop" and shows "a culture run amuck within News Corp. and a board that provides no effective review or oversight."

Murdoch and his companies will continue to be hit by a massive number of lawsuits. He'll also be brought into the arena of the criminal courts, although whether he personally is implicated is another matter. Besides the legal troubles, his personal fortune has taken a beating, as have the Murdoch family's finances. From May to August, News Corp. shares shed more than $1 billion in value due to the hacking scandal.

News Corp. will pay out monetary damages to settle lawsuits. Some underlings might go to jail, but the higher-ups will likely receive gentle slaps on the wrist as it becomes difficult to determine who knew what and when they knew it.

Through it all, Murdoch will remain involved. He will retain a board seat but will have to step down as chairman and CEO. However, it won't be because of the authorities or lawyers. Ultimately, the financial pressure on the stock shares and restoring investor confidence will win the day, but the issues of cronyism and boards' inherent economic conflicts of interest will not disappear. ■

Eric A.W. Danner, CIRA, is a partner at CRG Partners Group LLC.

1 Reprinted with permission from The Deal Magazine. Originally published October 14, 2011. Available online at http://www.thedeal.com/magazine/2011/10/ruperts_last_act/print/#ixzz1fyPQWUae

Valuation/Finance

Kenji Mochizuki, CIRA
Lecturer, University of Pennsylvania

MUNICIPAL BANKRUPTCY: ELEVEN DIFFERENCES BETWEEN CH 11 AND CH 9

Bankruptcy and turnaround professionals are now suddenly very interested in municipal bankruptcy. Since December 2010, analysts have been predicting an increase in municipal defaults and bankruptcies. On October 11, 2011, Harrisburg, Pennsylvania became the first U.S. state capital ever to file municipal bankruptcy. On November 9, 2011, Jefferson County, Alabama filed the largest Chapter 9 municipal bankruptcy in U.S. history.

While most bankruptcy professionals are less familiar with Chapter 9 of the Bankruptcy Code, many financial advisors are still interested in rendering services in distressed municipal situations and municipal bankruptcy proceedings. Thus, the next several articles of this Valuation / Finance section will focus upon municipal bankruptcy. But first, we must learn about Chapter 9 and understand how it differs from Chapter 11.

1) Debt Adjustment

Chapter 11 permits debt elimination, such that abuse of the bankruptcy process by the debtor is a possibility; however, Chapter 9 provides an insolvent municipality a practical mechanism only for voluntary municipal debt adjustment, not for debt elimination.

This is the most significant difference between Chapter 11 and Chapter 9, and changes the entire bankruptcy process for municipalities. By protecting a municipality from protracted disputes and debilitating litigation with creditors, Chapter 9 allows the municipality to continue borrowing and providing essential basic public services while resolving insolvency matters and settling disputes with creditors.

2) Eligibility

In Chapter 11, there is no insolvency requirement or eligibility requirement for being a debtor in the bankruptcy process. The corporate debtor enjoys the right to choose from more than one chapter of the Bankruptcy Code, i.e. Chapter 7 liquidation or Chapter 11 reorganization.

However in Chapter 9, a municipality that files a petition for relief must satisfy rather onerous eligibility criteria, such that it is much more difficult for a debtor to get into Chapter 9 than into Chapter 11. Once a bankruptcy judge is assigned to the case, the municipality must prove that it is eligible to be a debtor under Chapter 9 to obtain an order of relief.

This is no small feat: A large portion of Chapter 9 case law deals with eligibility issues, and approximately 25% of all Chapter 9 filings are dismissed because the putative debtor was unable to prove that it met these requirements. An entity is eligible to be a debtor under Chapter 9 if and only if such entity

1. is a "municipality";
2. is "specifically authorized" to be a Chapter 9 debtor under state law or by a duly-authorized state official (the following 20 States do not permit Chapter 9 filings: Alaska, Delaware, Hawaii, Indiana, Kansas, Maine, Maryland, Massachusetts, Mississippi, New Hampshire, New Mexico, North Dakota, South Dakota, Tennessee, Utah, Vermont, Virginia, West Virginia, Wisconsin, and Wyoming);
3. is insolvent based upon cash flow insolvency (not balance sheet insolvency) or is not paying its debts as they become due;
4. and desires to effect a plan to adjust its debts.

The fifth and final requirement is that the municipality must also prove that it: 1) obtained assent from a majority of each class of creditor to be impaired; or 2) negotiated in good faith with creditors but failed to obtain consent of the creditors; or 3) was unable to negotiate with creditors because such negotiation is "impracticable"; or 4) reasonably believes a creditor is going to get a preference.

These requirements are often to fulfill. There are several recent filings, for example, where an entity presumed to be a municipality was deemed by the court not to be a municipality after all. The Bankruptcy Code defines a municipality as a political subdivision or public agency or instrumentality of a State. Legislative history of Chapter 9 reveals that Congress intended the definition of municipality to be interpreted broadly such that a "political subdivision" generally includes cities, counties, and townships, and "public agency" and "instrumentality of a State" generally include hospital districts, public finance authorities, public improvement districts, school districts, and other revenue-producing bodies that are sponsored or controlled by the state.

3) Case Assignment to Judge

In Chapter 11, the clerk of the court automatically assigns the case by lot to a bankruptcy judge when the petition is filed. Because the debtor typically can choose to file in different states and among a variety of Districts, there is a kind of gamesmanship in the selection of a District where the specific judge assignment can be predicted with some certainty. Debtors often believe that a judge's practice background, case history and judicial track record might tend to lead to a favorable outcome. For example, a

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pharmaceutical debtor might hope that a judge with a healthcare background, who is debtor-friendly and has a good prior rapport with the debtor's attorneys and advisors, will be assigned the case.

In contrast, in Chapter 9 the Chief Judge of the Circuit in which the case is filed is responsible for assigning a bankruptcy judge to the case because of the rarity and importance of municipal bankruptcies. The Chief Judge is free to assign any bankruptcy judge in the Circuit to hear the case, and will consider whether a judge from the District in which the case is filed should be assigned.

This part of the Bankruptcy Code was designed to remove politics from the issue of which judge will preside over Chapter 9 cases involving major municipalities, and to ensure that a municipal case will be handled by a competent and experienced judge.

4) Power of Court

In Chapter 11, the role of the bankruptcy court is practically unlimited since everything outside the ordinary course of business must receive court approval. On the other hand, Chapter 9 is conducted without significant involvement of the bankruptcy court, except to oversee the entry and exit of a municipality from bankruptcy protection.

The powers of the bankruptcy court in a Chapter 9 case are generally limited to: 1) approving the bankruptcy petition if the debtor is eligible; 2) approving the debtor's assumption or rejection of executory contracts and unexpired leases; 3) confirming or denying the plan of debt adjustment; 4) ensuring implementation of the plan; and 5) dismissing the bankruptcy case under certain circumstances. Municipal debtors enjoy a degree of protection over their assets and operations that Chapter 11 debtors do not, because of the severe limitations placed on the power of the bankruptcy court by the Bankruptcy Code; by Tenth Amendment provision regarding any federal law that potentially interferes with the right of a state of sovereignty to govern the internal affairs of its municipalities; and by Supreme Court decisions in cases upholding municipal bankruptcy legislation.

As a practical matter, however, the judge in a Chapter 9 case does exert considerable influence over the parties in interest because of the implicit threat of dismissal of the bankruptcy case (discussed below). Furthermore, the municipal debtor may consent to have the judge exercise jurisdiction in many of the traditional areas of court oversight in bankruptcy in order to obtain the protection of court orders and to have issues decided in a single forum.

5) Order of Relief

The protection afforded by the order for relief is the purpose of filing for bankruptcy and grants the debtor relief from creditors until a Chapter 11 plan of reorganization (POR) or Chapter 9 plan of debt adjustment is approved. Upon a voluntary Chapter 11 filing, there is an automatic order for relief; however, under Chapter 9, the debtor must first fulfill certain requirements before the bankruptcy court can enter an order for relief, and thus allow the case to proceed. Months or years can pass by before the order for relief is issued, during which time the Chapter 9 debtor attempts to fulfill the requirements as outlined in the Bankruptcy Code. Thus upon entry into the Chapter 9 bankruptcy process, the initial game plan for the municipality centers upon obtaining an order for relief which is not assured in spite everything the municipality might do to meet the requirements.

Chapter 9 permits objections to the petition to be filed (for example, as to whether negotiations were conducted in good faith or whether the petition was filed in good faith) and the bankruptcy court must hold a hearing on each objection. If the petition is not dismissed upon these objections, the Bankruptcy Code requires the court to order relief, finally allowing the case to proceed under Chapter 9.

6) Dismissal

In Chapter 11 reorganization, bankruptcy cases can get dismissed and converted to Chapter 7 liquidation cases. Among other reasons, this might occur upon failure to timely file or confirm a plan of reorganization. The possibility of liquidation in corporate bankruptcy motivates all parties to seek a resolution.

However in Chapter 9, there is never a conversion to Chapter 7 because governmental entities cannot be liquidated. After all, a municipality is sovereign, and protected by the Eleventh Amendment to the U.S. Constitution. Deadlock and paralysis can and does result without the motivation provided by the implicit threat of liquidation. If the debtor cannot confirm a plan of debt adjustment, the only option available to the court and the creditors is dismissal of the Chapter 9 case. The Tenth Amendment to the U.S. Constitution and the Bankruptcy Code prevent the judge from crafting a plan of adjustment and and compelling the municipality to accept it.

The weapon of last resort in Chapter 9 becomes that of dismissal of the case for cause, even if the debtor is insolvent and the creditors would be better off without the dismissal. Dismissal would put the municipality out of court without protection of the bankruptcy process, i.e., the automatic stay, where the municipality will still be unable to pay debts.

7) Power of Trustee

In Chapter 11, the U.S. Trustee plays a visible role in corporate bankruptcy cases and enjoys a general supervisory authority that includes appointment of creditors' committees, enforcing reporting requirements, and organizing the first meeting of creditors.

However, the role of the U.S. Trustee is typically more limited in Chapter 9 cases, where there is no general supervisory authority other than appointment of creditors' committees. In Chapter 9, the U.S. Trustee does not examine the debtor at a first meeting of creditors (because there is no meeting of creditors), does not have the authority to move for appointment of a trustee or examiner or for conversion of the case, and does not supervise the administration of the case. Because the municipal debtor is not subject to the reporting requirements and other general duties of a Chapter 11 debtor, the U.S. Trustee does not monitor the financial operations of the debtor or review the fees of retained professionals and advisors.

In six judicial districts in the states of Alabama and North Carolina, the Bankruptcy Administrator serves a similar but more limited function in Chapter 9 cases as does the U.S. Trustee in Chapter 11.

8) Power of Creditors

The roles and powers of creditors are more limited in Chapter 9 than in Chapter 11 (to be discussed in a future issue of this section). But unlike in corporate bankruptcies, the creditors in municipal bankruptcies are often political constituents. Because of the tax-exempt status of most municipal bonds, individual retail investors are often residents of the issuer's locality.

Thus despite the limited role and powers of Chapter 9 creditors, the municipality must consider political ramifications and proceed delicately through debt adjustments. For example, it would be desirable to avoid a protracted and painful restructuring where essential services and goods might be cut to the anger of the voting public.

9) Power of Debtor

The Chapter 11 bankruptcy process is driven by the creditor, and the viewpoint shifts from that of the debtor to that of the estate. In Chapter 11, an estate is created where the debtor-in-possession (DIP) shares possession of its property with all of the creditors, and every action must promote the overall interests of both the creditors and the debtor. Chapter 11 debtors require court approval to take any action outside the ordinary course of business.

In Chapter 9, however, the debtor enjoys greater power. There is no concept of estate or debtor-in-possession in Chapter 9, and consequently there is no property of the estate for the Court to administer. Additionally because of the statutory limitations of the bankruptcy court discussed above, the Chapter 9 debtor has broad powers to use its property, raise taxes, make expenditures, and incur additional new debt. A municipality possesses the same power to obtain credit in Chapter 9 as it does outside of bankruptcy, and is permitted to borrow money as an administrative expense. The bankruptcy court does not have supervisory authority over the amount of debt incurred during operation of the municipal entity.

Lastly, the Bankruptcy Code provides the municipal debtor with powerful tools not found in Chapter 11. For example in Chapter 9, municipalities can reject the collective bargaining agreements (CBAs) and Other Post-Employment Benefits (OPEBs) that are currently so burdensome to distressed municipalities throughout the U.S. (to be discussed in an upcoming AIRA webinar and AIRA Self-Study Course).

10) Plan of Adjustment

In Chapter 11, the debtor enjoys a period of exclusivity during which no other party can propose a competing plan of reorganization. However in Chapter 9, there is no statutory time constraint for either the filing or confirmation of a plan of adjustment, and a creditor or other party in interest can never file its own plan. The entry into and exit from Chapter 9 are the two key steps in the bankruptcy process, and the debtor is largely free to create its own plan of debt adjustment.

11) Plan Confirmation

The confirmation requirements of Chapter 11 are also applicable to Chapter 9. However in Chapter 9, there are some additional requirements for plan confirmation not found in Chapter 11, especially in that all regulatory and electoral approvals necessary to consummate the plan of adjustment must already have been obtained.

Furthermore, the "best interests of creditors" and "fair and equitable" requirements to confirm a plan possess different meanings in Chapter 9 because the liquidation value of a municipal debtor is impossible to calculate since there are no shareholders of a municipality. In Chapter 11, the best interests test provides a floor for payments under a plan of reorganization such that creditors would receive at least as much as they would realize in a Chapter 7 liquidation. In Chapter 9, the plan of adjustment simply must be better than alternatives, namely dismissal of the bankruptcy case.

In Chapter 11, the fair and equitable requirement is the implementation of the absolute priority rule, where any senior class that rejects the plan of reorganization is paid in full before a junior class may receive or retain property under the plan. However in Chapter 9 where there are no holders of equity interests in a municipality, a plan of adjustment would provide creditors with the "going concern" value of their claims.

AIRA will soon release new resources on municipal bankruptcy: three AIRA Self Study Courses to be published in 2012 on the legal, financial, and accounting aspects of municipal bankruptcy.

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Bankruptcy Taxes

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IRS APPROVES CLEVER PLAN ALLOWING DEDUCTION OF BANKRUPTCY REORGANIZATION COSTS

The Internal Revenue Service has long taken the position that bankruptcy administrative expenses incurred in a bankruptcy reorganization treated as a nontaxable Type G reorganization are not immediately deductible and must be capitalized. IRS does concede those same expenses are deductible in a liquidation case. In Private Letter Ruling 201138022, the investment fund acquiring the emerging entity in a Chapter 11 case managed to construct a taxable transaction so that there was no Type G taxfree reorganization which led ultimately to the immediate deduction of the bankruptcy administrative expenses.

For tax purposes, we are usually trying to qualify a Chapter 11 reorganization in which an entity emerges as a nontaxable Type G reorganization (IRC Sec. 368(a)(1)(G)). But in this case, the parties must have calculated that there would be little advantage in qualifying as nontaxable and the alternative treatment as a taxable sale was more beneficial. (The terminology in this area is a little confusing as the term "reorganization" as used in Chapter 11 of the Bankruptcy Code broadly comprehends any situation in which a business is continued in some emerging entity. However, Sec. 368 of the Internal Revenue Code has a narrow definition of a reorganization as one of a group of transactions which are generally nontaxable, provide for carryover stock basis, etc. Type G bankruptcy reorganizations are just one type of such transactions.)

In the ruling the debtor entity incurred substantial bankruptcy administration costs and financing costs in facilitating Debtor in Possession (DIP) financing. An auction of the business assets was held and an "Investment Fund" which was an existing creditor was the successful bidder for all assets. The Investment Fund then formed "New Parent" capitalizing it with cash, borrowed funds and some Investment Fund stock. The New Parent then exchanged the cash and New Parent stock with Debtor for all assets. Debtor then liquidated. Pursuant to the Plan, the former equity holders of Debtor received nothing and creditors could elect whether to receive cash or New Parent stock. The Investment Fund was the only creditor who elected to receive New Parent stock.

The question then is whether this constitutes a Type G taxfree reorganization or a taxable sale? The definition of a Type G reorganization is:

> "a transfer by a corporation of all or part of its assets to another corporation in a title 11 or similar case; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354 [requiring the distribution of stock or securities]….."

Thus the statute requires that at least one prior Debtor shareholder receive stock or securities (long term debt) in the emerging entity or a security holder of the Debtor receives stock or securities. We already said the old equity holders were to receive nothing and all creditors except the Investment Fund only received cash. If the Investment Fund's prior loan to the Debtor was less than 5 years in term, it would not constitute a "security." Thus, no security holder received any of the New Parent stock. This probably positioned the taxpayers to represent to IRS that the exchange did not qualify as a Type G reorganization and thus it would be a taxable sale.

There are three beneficial consequences of taxable sale treatment in this situation:

1. Since there was no reorganization, the bankruptcy administrative expenses did not have to be capitalized but could be expensed by the Debtor on liquidation.
2. Since the financing expenses were related to DIP financing during the period of administration of the case, those expenses were deductible upon liquidation also.
3. Though not discussed in the ruling, the tax basis of the assets was probably stepped up to fair market value in the hands of New Parent for purposes of depreciation, amortization or sale as this is a normal consequence of a taxable sale.

Conclusion—I am guessing that the step-up in fair market value of the assets in the hands of New Parent was the real goal of this transaction though the letter ruling does not say so. Usually liquidating bankrupt entities have plenty of ordinary operating deductions and do not need more. In this case, the taxable sale treatment of the assets probably created some taxable income for the Debtor and the administrative and financing expense deductions were needed to offset that income. It is an artful and interesting transaction that shows how an emerging entity transaction can be structured to be either a Type G taxfree reorganization or a taxable sale.

ADVISORS' TOOLKIT – THE TAXFREE CORPORATE SPINOFF

The spinoff is a very useful tax technique available to both public and private corporations for separating one or more active businesses from a group of active businesses and transferring ownership to all or some of the current ownership group on a taxfree basis under Internal Revenue Code Section 355. The corporation making the transfer is known as "Distributing" and the corporation transferred is referred to by the Internal Revenue Service as the "Controlled" corporation but in this article it will be referred to as the "Target." If all of the requirements are met, the transfer of shares is neither taxable to the recipient shareholders nor has any adverse tax effects on the distributing corporation. Asset bases and accounting methods within the corporation remain the same. Recipient shareholders allocate basis to the stock received based on relative fair market values. (Reg. 1.358-2)

In fact, there are three main variations of the spinoff depending on the groups of shareholders benefitted:

- In a ***spinoff***, the Distributing corporation's shareholders receive the stock of the Target corporation without surrendering any of their stock, so in a sense it resembles a dividend.
- In a ***split off***, the shareholders receiving stock of the Target corporation surrender some or all of their Distributing stock, so it resembles a redemption.
- In a ***split up***, one group of shareholders receive the stock of one Target and another group of shareholders receive another Target holding the remaining subsidiary or subsidiaries, and the distributing parent dissolves.

For the rest of the article, all three subtypes will simply be referred to as a "spinoff." As you can see, the spinoff is an extremely flexible and useful tool.

While there are numerous requirements to qualify for a taxfree spinoff, by far the most problematic is the one discussed first, the "active business requirement":

- *Active Business*—both the Target and the remaining parent Distributing (or other Target in the case of a corporate split up) must contain an active business which they have operated for five years. An active business generally does not include the ownership of a portfolio of passive investments nor renting out of real or personal property.
- *Control*—immediately before the spinoff, Distributing must own 80 percent of the total combined voting power and 80 percent of the total number of shares of all other classes of stock of the Target, including nonvoting preferred stock.
- *Plan of Reorganization*—like all taxfree reorganizations, a taxfree spinoff must be pursuant to a written plan of reorganization. IRS requires that the plan of reorganization must be adopted by each of the corporations that are parties thereto.
- *Distribution of All Stock or Securities*—Distributing must transfer all the stock or securities of the Target that the distributing corporation holds or an amount of stock sufficient to meet the control test described above.
- *Not a "Device" for Distribution of Earnings*—while meeting the active business test reduces the latitude for a disguised dividend, the Internal Revenue Service still can attack a transaction based on the facts and circumstances of the case. One fact indicating a device to distribute earnings would be "stuffing" the Target with cash or marketable securities just before the spin.
- *Business Purpose*—another critical requirement is the need for a corporate level business purpose. Shareholder tax saving is not a corporate business purpose. Among the common business purposes recognized are "fit and focus" especially to resolve shareholder or family hostility, cost saving, to facilitate acquisition of Distributing by a third party or to facilitate an acquisition by Distributing or the Target.
- *Continuity of Interest*—this is one of the more easily met requirements in a spinoff, as the regulations primarily require that at least some of those who were shareholders immediately before the distribution continue as shareholders after the distribution, but see the so called "Morris Trust" rules below.

"Pre-arranged acquisition" (or Anti-Morris Trust Rules)

In the 1960s the taxpayer won a case involving a tax free spin off followed by a Type A or B taxfree acquisitive reorganization of the Target by a third party. Congress concluded that the conjunction of a taxfree spinoff of specific assets followed by a taxfree acquisition of those assets was too much of a good thing. In 1997 the Congress enacted a strange provision which focuses on any prearrangement of an acquisition, taxable or nontaxable, in contemplation of the spinoff. If such a plan can be proven to exist within two years before or after the spinoff, then the distributing corporation is subjected to tax on a gain measured by the fair market value of the assets of the controlled corporation less their tax basis. (Sec. 355(e) and (f))

Drop-down transactions to facilitate a spinoff

The tax law does contain a favorable reorganization known as Type D (Sec. 368(a)(1)(D)) to facilitate a spinoff. If a corporation holds two active businesses in the same corporate shell such as two separate divisions, it is allowed to drop the target business assets and liabilities into a new corporation in preparation for the spinoff to shareholders.

Getting ruling letter protection

In spinoff transactions involving public corporations and large private ones, it is common to get a private letter ruling from IRS as to the nontaxability of the transaction. In fact, the IRS received so many requests that it announced that it will no longer rule on the business purpose test but it will generally rule on the other aspects of a spinoff. (Rev. Proc. 2003-48)

Conclusion

Since the 1986 Tax Act made it much more difficult to remove assets from corporate solution without incurring substantial federal income tax, the use of Sec. 335 spinoffs has exploded. The spinoff remains a highly useful and flexible tool for moving assets from corporation to shareholder if the assets constitute an active business with a five year history and the other tests can be met.

IRS PAVES WAY FOR DERIVATIVE CLEARINGHOUSES

The financial market meltdown of 2009 caused financial institution regulators to push for the creation of a clearinghouse for derivatives to rationalize the derivative market and in the last few years, several clearinghouses have been created. The Internal Revenue Service is playing its part by issuing a temporary regulation to address a concern encountered in the unwinding of some Fannie Mae interest swaps. (Reg. 1.1001-4T) An interest swap derivative is a sort of financial insurance policy to help mitigate interest rate risk. Typically an investor or institution targeting to issue a bond, at say 4%, buys a contract from a large broker to provide payment in case interest rates rise and the bond can't be sold at 4%. A long term problem in this so called "over

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the counter derivative market" is that the instruments can have lives as long as 10 or 15 years, so as time goes on a major player in that market builds up a deep inventory of unclosed positions. It is thought this long, complicated "tail" can be eliminated in the future through a clearinghouse which can assume or close out those positions. In addition, since the positions taken by the various brokers participating in that market necessarily net to zero, some of the "entity" risk of the 2009 style meltdowns can be avoided. However, a perceived tax risk is hampering the willingness of some market players to transfer swap contracts.

The general rule of Reg. 1.1001-1 is that "the exchange of property for other property differing materially either in kind or in extent, is treated as income." Under this rule the Supreme Court held in the landmark Cottage Savings Association case that the swap of portfolios of loan participation interests by financial institutions was a recognition event, albeit a loss in that case. The preamble to the new regulation says it was prompted by problems encountered by Fannie Mae in disposing of interest rate swaps it held. Some of the counterparties to the Fannie Mae swaps refused to cooperate in assignment of their contracts for fear it would constitute a taxable event to them, a premature "close out" of the position so to speak. The temporary regulation which is set to expire in 2014 clarifies:

- The substitution of a new party on a notional principal contract is not treated as a deemed exchange of the contract by the nonassigning party (which we will refer to as the "counterparty" for simplicity) for purposes of §1.1001-1(a) if two conditions are satisfied: the assignment is between dealers in notional principal contracts, including a clearinghouse, and the terms of the contract permit the substitution.
- If the contract permits assignment only with the consent of the counterparty, there has been some uncertainty as to whether granting that consent creates taxable gain to the counterparty. If consideration is paid to the assignor by the assignee, that will not cause the transaction to be taxable to the counterparty. However, if the counterparty receives consideration for its consent, the transaction will be tested under the general rules of Section 1001, i.e. it can be a taxable sale.
- The underlying contract cannot be changed in its material terms or it may be treated as a taxable exchange.
- The rules of Section 1001 and these rules apply to all types of derivatives and swaps, not just notional principal contracts.

Example

Fannie Mae had acquired an interest swap covering a package of mortgages at 4% from Goldman Sachs. Regulators now want Fannie Mae to assign that swap package to a clearinghouse, which we will call the Federalized Credit Risk Association, which will require Fannie Mae to pay the clearinghouse a fee. Under the temporary regulation, the tax position of Goldman Sachs is unaffected by the assignment.

Conclusion

These rules will help bring certainty to transactions in this marketplace.

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

NEW IRS ADDRESS FOR CERTAIN CENTRALIZED INSOLVENCY FILINGS

Announcement 2011-77, I.R.B. 2011-51 (November 30, 2011) informs bankruptcy trustees (or debtors-in-possession) of a change of address for the Centralized Insolvency Operation that should be used for the submission of

- requests for tax refunds under section 505(a) of the Bankruptcy Code or
- requests for prompt determinations of any unpaid tax liability of the estate incurred during the bankruptcy case under section 505(b) of the Bankruptcy Code.

This announcement also describes where further information concerning additional requirements for filing those requests may be found.

Rev. Proc. 2010-27, 2010-2 C.B. 183, informs bankruptcy trustees (or debtors-in-possession) of the application procedure to be followed to properly request a tax refund from the Service under section 505(a) of the Bankruptcy Code. Rev. Proc. 2006-24, 2006-1 C.B. 943, establishes the procedure by which bankruptcy trustees (or debtors-in-possession) may request from the Service a prompt determination of any unpaid tax liability of the estate incurred during the bankruptcy case under section 505(b) of the Bankruptcy Code. Both Rev. Proc. 2010-27 and Rev. Proc. 2006-24 provide that requests must be filed with the Centralized Insolvency Operation.

The new address, effective immediately, is:

Centralized Insolvency Operation
P.O. Box 7346
Philadelphia, PA 19101-7346.

Further information concerning additional requirements, including updated address information for service of requests, may be found on a webpage on the IRS's website, www.IRS.gov. To access this webpage, type http://www.irs.gov/ into the address box on your internet browser. Once the webpage opens, type "IRS Tips for Bankruptcy Trustees" into the search field in the top right hand corner of the webpage. ■

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Bankruptcy Cases

Professor Baxter Dunaway

BANKRUPTCY

Fourth Circuit

Is "good faith,, as used to defend against bankruptcy trustee's recovery of avoidable property transferred from the debtor's estate, to be determined under an objective standard?, and (2) did mediate transferee of an avoided transfer not take in good faith and without knowledge of the voidability of the transfer?

In ***Goldman v. City Capital Mortg. Corp. (In re Nieves)***, No. 08– 2160, 2011 WL 2279423, at * 6 (4th Cir. June 10, 2011) (per curiam), the Fourth Circuit addressed the concept of "good faith" in the context of a section 550(b)(1) affirmative defense.

Section 544 of the Bankruptcy Code allows the bankruptcy trustee to "avoid any transfer of an interest of the debtor in property ... that is voidable under applicable law by a creditor holding an unsecured claim." 11 U.S.C. § 544(b). This section is commonly used to avoid, under state law, fraudulent transfers from the Debtor's estate.

In addition to avoiding transfers, the bankruptcy trustee is allowed to recover the avoidable property, or the value of such avoidable property, from "the initial transferee" or "any immediate or mediate [*i.e.,* subsequent] transferee of [an] initial transferee." 11 U.S.C. § 550(a). A trustee has an absolute right to recover from the initial transferee. § 550(a)(1). Any immediate or mediate transferee of the initial transferee, however, has an affirmative defense to recovery if such transferee "takes for value, ... in good faith, and without knowledge of the voidability of the transfer avoided." § 550(b)(1). "[O]nce the plaintiff has established that a party is an immediate or mediate transferee of the initial transferee, a defendant claiming a defense to liability under § 550(b) bears the burden of proof."

The Fourth Circuit determined that "[t]he good faith standard applicable to immediate and mediate transferees should be the same as the good faith standard for initial transferees," which is the defense in section 548(c). Consistent with previous Fourth Circuit precedent, the court "appl[ied] an objective good faith standard for the defense available to immediate and mediate transferees in § 550(b)(1)." *Id.* at * 6– 9. Transferees asserting an affirmative defense under section 550(b)(1) "do not take in good faith if they remain willfully ignorant in the face of facts which cry out for investigation." *Id.* (citation and internal quotation marks omitted). The court also recognized that an "objective" analysis of the good faith standard "comports with other areas of commercial law." *Id.*

The court concluded that good faith "contains both subjective ('honesty in fact') and objective ('observance of reasonable commercial standards') components." *Id.* Under the subjective prong, a court looks to "the honesty" and "state of mind" of the party acquiring the property. *See, e.g. Triffin v. Pomerantz Staffing Servs., LLC,* 370 N.J.Super. 301, 851 A. 2d 100, 104 (N.J.Super. Ct.App.Div.). Under the objective prong, a party acts without good faith by failing to abide by routine business practices. *See Rudiger Charolais Ranches v. Van De Graaf Ranches,* 994 F. 2d 670, 672– 73 (9th Cir. 1993) (reasonable commercial practice includes a "custom or practice" unless in conflict with a statute); *see also* Grant Gilmore, *The Commercial Doctrine of Good Faith Purchase,* 63 Yale L.J. 1057, 1122 n. 22 (1954) (good faith standard captures routine business practices of industry). The court therefore arrived at the conclusion that the objective good-faith standard probes what the transferee knew or should have known, *see Gold v. Laines (In re Laines),* 352 B.R. 397, 406 (Bankr.E.D.Va.2005), taking into consideration the customary practices of the industry in which the transferee operates.

In so holding, the court arrived at the same conclusion as the three other circuit courts that have addressed the issue. *See Brown,* 67 F.3d at 1355; *Hayes v. Palm Seedlings Partners (In re Agric. Research & Tech. Group, Inc.),* 916 F.2d 528, 535–36 (9th Cir.1990); *Bonded Fin. Servs., Inc. v. European Am. Bank,* 838 F.2d 890, 897–98 (7th Cir.1988). *Id. *5.*

First Circuit

Do § 362(a)(1) of the Bankruptcy Code and its tolling provision, § 108(c), combine to preserve a mortgagee's right to commence a foreclosure action, notwithstanding a readily available extension provided by a state obsolete mortgages statute?

Shamus Holdings, LLC v. LBM Fin., LLC (In re Shamus Holdings, LLC), 642 F.3d 263 (1st Cir. 2011) holds that Section 108(c) of the Bankruptcy Code tolls the period under state law, Massachusetts mortgage law Obsolete Mortgages Statute, within which a mortgagee must enforce a mortgage following maturity of the secured debt.

Obsolete Mortgages Statute, Mass. Gen. Laws ch. 260, § 33, requires the holder of a mortgage, on pain of forfeiture, to take action to enforce a mortgage within five years after the end of the mortgage's stated term. Here, the statute required the mortgagee to take action to enforce its mortgage by September 9, 2008. This deadline had not arrived when the debtor instituted a bankruptcy proceeding.

Under ordinary circumstances, the Bankruptcy Code tolls the running of the limitations period from the filing date until the automatic stay is either lifted or dissolved. *See* 11 U.S.C. § 108(c). In the debtor's view, however, the Obsolete Mortgages Statute alters this calculus by allowing a mortgagee to extend the limitations period through the simple expedient of recording a notice of extension. Debtor argued that mortgagee's failure to avail itself of this procedure within the five-year period converts the automatic stay into a dead letter.

Nevertheless, the Court of Appeals held that literal provision of 11 U.S.C. § 108(c) tolls the limitations period set by the Massachusetts Obsolete Mortgages Statute, thereby enlarging the time within which the mortgagee can bring a judicial

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foreclosure action until after the termination or expiration of the automatic stay.

Eleventh Circuit

Is the mere recordation of fees incurred by a lender in its internal records, without any attempt to collect those fees from the debtor or estate or to modify the mortgage, an "act" in violation of the automatic stay § 362(a)(3)?

With regard to the automatic stay, the mere recordation of fees incurred by a lender in its internal records, without any attempt to collect those fees from the debtor or estate or to modify the mortgage, is not an "act" in violation of § 362(a)(3). ***Jacks v. Wells Fargo Bank, N.A. (In re Jacks)***, 642 F. 3d 1323 (11th Cir. 2011).

First Circuit

Did bankruptcy court err by not allowing debtors an opportunity to present evidence of damages after finding willful violation of automatic stay?

The First Circuit, after finding willful violation of automatic stay, held that the bankruptcy court erred by not allowing debtors an opportunity to present evidence of damages under Code section now codified as § 362(k). ***Laboy v. Doral Mortg. Corp. (In re Vazquez Laboy)***, No. 09-9022, 2011 WL 2119316 (1st Cir. May 27, 2011.

Research References: Norton Bankr. L. & Prac. 3d § 43:57

West's Key Number Digest, Bankruptcy 2467

Second Circuit

Is bankruptcy Trustee immune from suit for personal liability for acts taken as a matter of business judgment when acting in accordance with statutory or other duty or pursuant to court order?

The Second Circuit held that a bankruptcy Trustee is immune from suit for personal liability for acts taken as a matter of business judgment when acting in accordance with statutory or other duty or pursuant to court order. ***Smith v. Silverman (In re Smith)***, No. 10-1565-bk (L), 645 F.3d 186, 189, 2011 WL 1901040 (2d Cir. May 20, 2011). In holding against the debtor/appellant, the court stated:

> The gravamen of appellants' putative complaint is that the trustee negligently failed to pursue certain legal claims belonging to the bankruptcy estate. "[A] bankruptcy trustee is immune from suit for personal liability for acts taken as a matter of business judgment in acting in accordance with statutory or other duty or pursuant to court order." *In re Ctr. Teleprods., Inc.,* 112 B.R. 567, 578 (Bankr.S.D.N.Y.1990); *see also In re M & S Grading, Inc.,* 541 F.3d 859, 867 (8th Cir.2008) (affirming under the business judgment rule the bankruptcy court's approval of a bankruptcy trustee's decision not to pursue litigation on behalf of the estate). As both the Bankruptcy Court and the District Court determined, the trustee exercised his sound business judgment in declining to assume the expense of raising and/or pursuing the legal claims identified by appellants. 645 F.3d 186, 189 (2nd Cir. (N.Y.).

Research References: Norton Bankr. L. & Prac. 3d § 26:18

West's Key Number Digest, Bankruptcy 3001

Seventh Circuit

Would a cramdown plan that provided for selling the Chapter 11 debtors' encumbered assets free and clear of liens in an auction where credit bidding would not be allowed qualify as"fair and equitable" under 11 U.S.C.A. § 1129(b)(2)(A)?

The Seventh Circuit held that a cramdown plan that proposed selling the Chapter 11 debtors' encumbered assets free and clear of liens in an auction where credit bidding would not be allowed could not qualify as "fair and equitable" under 11 U.S.C.A. § 1129(b)(2)(A), even if it satisfied the Bankruptcy Code's "indubitable equivalence" standard. ***River Road Hotel Partners, LLC v. Amalgamated Bank***, --- F.3d ----, 2011 WL 2547615, 55 Bankr.Ct.Dec. 13, Bankr. L. Rep. P 82,031 (7th Cir. (Ill.) Jun 28, 2011) (NO. 10-3597, 10-3598). The Seventh Circuit agreed with Judge Ambro's dissent in *In re Philadelphia Newspapers, LLC*, 599 F.3d 298 (C.A.3-Pa. 2010). The Court stated an "overview and precedents": 2011 WL 2547615, *4-*5:

> **(1) Overview of Section 1129(b)(2)(A) and Relevant Precedents**
>
> Before attempting to decipher Section 1129(b)(2)(A)'s proper meaning, a brief review of the statute and the way it has been construed by the courts is merited. Section 1129 of the Code sets forth the criteria that a debtor's Chapter 11 reorganization plan must satisfy to be confirmed by a bankruptcy court. While the Code generally requires that reorganization plans be accepted by each class of claimants (or, alternatively, leave the claims of non-assenting classes unimpaired), *see* 11 U.S.C. § 1129(a)(8), Subsection (b) of Section 1129 excepts certain plans from this requirement. Plans that are confirmed under Section 1129(b) are often referred to as cramdown plans because they have been "crammed down the throats of objecting creditors." *Kham & Nate's Shoes No. 2, Inc. v. First Bank*, 908 F.2d 1351, 1359 (7th Cir.1990). Subsection (b)(1) states that, in order for a plan to be confirmed over the objection of a class of creditors, it must be "fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan." Subsection (b)(2)(A) defines what constitutes "fair and equitable" treatment in the secured creditor context. It states that a plan is "fair and equitable" if it 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 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

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

11 U.S.C. § 1129(b)(2)(A).

Traditionally, the majority of cramdown plans have sought confirmation under Subsection (ii) of 1129(b)(2)(A). Given the detailed and carefully tailored language used in this subsection, it has rarely been difficult for courts to determine whether plans qualify for "fair and equitable" status. Plans that propose selling an encumbered asset free and clear of liens could be confirmed over the objections of secured creditors so long as the debtor's asset sale complies with Section 363(k) of the Code. Sales comply with Section 363(k) if they permit parties with secured claims to "offset [their] claim against the purchase price of [the asset]" when entering bids to purchase the asset, an arrangement that is popularly referred to as credit bidding.

An increasing number of debtors, however, have begun to seek confirmation of their plans under Subsection (iii) of 1129(b)(2)(A). Because the language used in this provision is both sparse and general, determining whether a reorganization plan can qualify as "fair and equitable" under this subsection is no simple task. As written, the statute does not provide guidance concerning (1) what types of plans fall within Subsection (iii)'s scope or (2) what constitutes the "indubitable equivalent" of a secured creditor's claim. Resolving the first issue is not easy because nothing in the text of Section 1129(b)(2)(A) indicates whether subsection (iii) can be used to confirm every type of reorganization plan or only those plans that fall outside the scope of Subsections (i) and (ii). Resolving the second issue is difficult because "indubitable equivalent" is not a term that has been defined by the Code or the courts. *In re Pacific Lumber, Co.*, 584 F.3d 229, 246 (5th Cir.2009) (noting that "[w]hat measures constitute the indubitable equivalent of the value of the [secured creditor's] collateral are rarely explained in case law").

Two of our sister circuits recently issued opinions analyzing Section 1129(b)(2)(A). *Philadelphia Newspapers,* 599 F.3d 298; *Pacific Lumber,* 584 F.3d 229. In *Pacific Lumber,* the Fifth Circuit held that a plan that proposed the sale of the debtor's encumbered assets to a specified purchaser for an amount equal to the judicially-determined value of the assets qualified as "fair and equitable" under Subsection (iii) of Section 1129(b)(2)(A). *Pacific Lumber,* 584 F.3d at 249. In *Philadelphia Newspapers,* the Third Circuit held, in a 2–1 decision with one of the members of the majority concurring in the judgment, that a plan that proposed selling the debtor's encumbered assets free and clear of liens in an auction where credit bidding would not be allowed could qualify as "fair and equitable" under Subsection (iii). *Philadelphia Newspapers,* 599 F.3d at 318. Both majority opinions held that Subsection (iii)'s scope was not limited by its neighboring subsections and that the proceeds from the sale of encumbered assets constituted the indubitable equivalent of the secured creditors' claims. Judge Ambro's dissent in *Philadelphia Newspapers* rejected both of these conclusions, arguing that the majority's reading of the statute was at odds with the text of the statute itself, various canons of statutory interpretation, the statute's legislative history, interests expressed in other parts of the Code and the settled expectations of lenders and borrowers.

Fourth Circuit

Must a debtor claim an exemption as precondition of avoiding judicial lien under 11 U.S.C.A. § 522(f)(1) on the basis that lien impairs exemption?

The Court of Appeals, held that debtor need not claim an exemption as precondition of avoiding judicial lien under 11 U.S.C.A. § 522(f)(1) on the basis that lien impairs exemption. ***Botkin v. DuPont Community Credit Union***, --- F.3d ----, 2011 WL 2307638, Bankr. L. Rep. P 82,019 (4th Cir.(Va.) Jun 13, 2011) (NO. 10-1681).

In addition to the rights to exempt certain property from the bankruptcy estate, debtors also, under 11 U.S.C.A. § 522(f), can move to avoid, or wipe out, a lien or interest that a creditor has in particular property. It is this right that is the subject of the appeal. 11 U.S.C.A. § 522(f)(1) provides, as is relevant here, that a debtor "may avoid the fixing of a lien on an interest of the debtor in property to the extent that such lien impairs an exemption to which the debtor would have been entitled under subsection (b) of this section, if such lien is ... a judicial lien." 11 U.S.C.A. § 522(f)(2) defines when a lien "shall be considered to impair an exemption": It is considered to do so to the extent that the sum of (i) the lien;(ii) all other liens on the property; and(iii) the amount of the exemption that the debtor could claim if there were no liens on the property; exceeds the value that the debtor's interest in the property would have in the absence of any liens.

DuPont argued that the district court erred by concluding that a debtor can avoid a judicial lien under § 522(f) without having already claimed an exemption in the property subject to the lien. ■

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These will assist bankruptcy and turnaround professionals seeking to learn quantitative and qualitative approaches to analyzing and advising municipal bankruptcy situations. ■

Kenji Mochizuki, CIRA, Section Editor, currently works in bankruptcy / restructuring / M&A advisory as well as distressed investing, which includes serving as advisor to a distressed municipal bond hedge fund and heading a team of credit analysts. Kenji is the author of the chapter on municipal defaults and bankruptcy in a John Wiley & Sons, Inc. / Bloomberg Press book currently in press, titled "Investing In The High Yield Municipal Market". Anyone seeking advisory opportunities in municipal bankruptcy is welcome to submit a resume to Kenji at VCPE_jobs@yahoo.com

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