Bankruptcy: Special Topics

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Agenda

- How to get paid.
- Tax aspects of § 363 asset sales.
- Valuing assets in bankruptcy.

How to Get Paid:
§ 328 vs. § 330 of the Bankruptcy Code

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Retention Application/Agreement

- Allows the trustee of a bankruptcy estate, "with the court's approval," to employ one or more professional entities (including accounting firms) to represent or assist the trustee in administering the estate. B.C. § 327.

- Sounds straightforward. So of course, it isn't. The hang-up usually comes in the "with the court's approval" area.

- When a court is asked to approve professional fees in a bankruptcy case, it will look to either § 328 or § 330 of the Bankruptcy Code to determine the appropriate level of those fees.

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- § 328 vs. § 330 presents a rare case of "better to ask **permission** than forgiveness."

- § 328 and § 330 each address the compensation that may be paid to professionals. The problem is courts interpret them differently.

- In compliance with the bankruptcy code, all firms enter into written retention agreements that state "fees are subject to court approval" or other similar language.

- By not specifying whether the court's “approval” should be governed by § 328 or § 330, the parties are leaving to the court an unnecessary expanse of discretion to make an important decision.

- That decision will directly affect the level of compensation the professional ultimately receives.

- If professionals do not indicate which of those two sections should apply, the bankruptcy judge will almost always opt for the broader discretion granted by § 330.

- When reviewing professional fees under § 330, the court will review the professional's fees to determine whether those fees are "reasonable."

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§ 330: Court Determines "Reasonable Amount"

- Although § 330(a)(3) lists several factors a court must consider when determining the reasonableness of a professional's compensation, these factors are **subjective**, giving a court the ability to award fees in a "**reasonable amount**."
- However, what the court decides is a reasonable amount may very well be **less** than that specified in the compensation agreements executed by the parties and requested by the professional.

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- Therefore, the first step an accounting firm should take in its effort to minimize the likelihood that its fee will be reduced or contested is to include language in the retention application expressly indicating that § 328(a), and not § 330, will govern the compensation the firm receives.

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§ 328: Court Bound by Fee Agreement

- The purpose of § 328 is to permit the pre-approval of those fixed terms of compensation arrangements recognized by the market as a method of insuring that the most competent professionals are available to provide services in bankruptcy cases.

See In re Westbrooks, 202 B.R. 520, 521 (N.D. Ala. 1996) (fixed percentage fee arrangements with law firms "comport with the Bankruptcy Code's goal of attracting highly qualified professionals to the bankruptcy forum")

- Once the terms of a professional’s retention have been approved under § 328(a), the judge's award must follow the agreed-upon compensation and cannot be altered unless the terms “prove to have been **improvident** in light of developments not capable of being anticipated at the time of the fixing of such terms and conditions.”

- The following cases illustrate the importance of this distinction.

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In re Gillett Holdings Inc.
143 B.R. 256 (Bankr. D. Colo. 1992)

- Smith Barney filed an application with the bankruptcy court for the interim allowance of compensation and reimbursement of expenses for services the firm rendered to Gillett Holdings Inc. related to Gillett's chapter 11 reorganization.
- In its order authorizing employment of Smith Barney, the court stated that the "compensation and reimbursement for expenses of Smith Barney [are] to be fixed by further order of the court."
- The total fees sought by Smith Barney came to $800,000 but the court, analyzing the fee request under the "reasonableness" standard of § 330 rather than the fixed unless "improvident" standard of § 328, slashed this amount by $501,656.75 and awarded Smith Barney only $298,343.25.

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In re Gillett Holdings Inc. (cont.)

- The *Gillett* court stated that the "deference afforded under § 328(a) does not apply unless the appointment order expressly and unambiguously state[s] specific terms and conditions . . . that are being approved pursuant to the first sentence of § 328(a)."
- By not carefully specifying in its engagement letter and application to be employed that § 328(a) was to control any review of compensation agreed to by the parties, Smith Barney left itself open to later reductions of its fees by the court under § 330.
- *Gillett* thus warns that accounting firms should take great care to ensure that fee applications, and the subsequent court orders approving those applications, include language unambiguously stating that the fees are subject to § 328(a) and not § 330.

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- Even when § 328(a) applies, a court may change the fees paid to a professional if the original terms of the fee agreement "prove to have been improvident in light of developments not capable of being anticipated at the time of the fixing of such terms and conditions."
- In plain English, this means that if the parties could have anticipated the occurrence of events that ultimately make the fee imprudent, the fee will stand.

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In re Barron

- The court refused to reduce a law firm's fee even though the firm was able to obtain a substantial judgment in a short amount of time with relative ease. The court held that such an outcome was foreseeable at the time the parties entered the fee agreement.
- If, on the other hand, the parties could not have reasonably anticipated the occurrence of events that ultimately render a professional's fees imprudent, a court is free under §328(a) to alter the fees.

In re Home Express

- Yet, not all unanticipatable events will lead to a reduction in the professional's fees. In *Home Express Inc.,* the court allowed four professional firms to increase their fees by a total of approximately 15%, or $295,000.
- In *Home Express,* the turnaround team initially put in place quit after a few months, creating a "managerial vacuum" at the debtor that required the four professional firms to increase their labor and risks, thereby justifying the fee increase.
- Because this managerial vacuum was not foreseeable at the time the court initially approved the parties' fees, the court ruled that §328(a) applied and the fee increases requested by the professionals were granted.

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Conclusion

- Accounting firms should be aware that courts have the authority to deny or reduce the fees a firm receives for services performed in a corporate reorganization.
- By clearly stating in the retention agreement that U.S. Bankruptcy Code § 328(a), and not § 330, is the applicable standard by which a court should review the fees charged, an accounting firm stands a much better chance of protecting itself against court-imposed fee reductions later.

Tax Aspects of § 363 Asset Sales

Tax Aspects of § 363 Asset Sales

- Section 363 of the Bankruptcy Code allows a debtor corporation in a Chapter 11 reorganization to sell some or substantially all of its assets through a court-supervised auction.
- This allows the sale to take place before and outside of the process for confirming the debtor's plan of reorganization that would otherwise require the vote of creditors.

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Tax Aspects of § 363 Asset Sales

- Assets sold pursuant to § 363 are generally transferred free and clear of liens and other prior interests.
- To be free and clear of any "interest in property," such sales must meet at least one of the following conditions:
  - Applicable non-bankruptcy law allows such a sale free and clear of such interest.
  - The entity consents.
  - The interest is a lien and the selling price is more than the aggregate value of all liens on the property.
  - Interest is in a bona fide dispute.
  - The entity could be compelled to accept a monetary satisfaction of the interest (i.e., in a foreclosure or under receivership).
    - § 363(f) of the Bankruptcy Code.

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Tax Aspects of § 363 Asset Sales

- From the federal income tax perspective, § 363 sales occur in one of two forms: a taxable asset sale under IRC § 1001 or a nontaxable reorganization (like G reorganizations).
  - 11 USC 368(a)(1)(G)
- In a taxable asset sale under IRC § 1012, the purchaser takes a cost basis equal to fair market value of assets at purchase plus the liabilities of seller assumed by purchaser.

Tax Aspects of § 363 Asset Sales

- The debtor/seller's tax attributes do not carry over to the purchaser. None of the reductions to debtor/seller's tax attributes (NOLs, etc.) impact the purchaser's attributes.
- Because debtor/seller's tax attributes do not flow to purchaser, the seller is able to use its NOLs to shelter any gain on the sale.
- Also, any loss generated by the sale can usually be used to shelter other income of the debtor (or other members if filing as a consolidated group).

Tax Aspects of § 363 Asset Sales

- To be considered a tax-free transaction (more correctly, a “tax-deferred” transaction), the most popular method is through IRC § 368(a)(1)(G) (a.k.a. “Type G reorganization”).
- In a Type G reorganization, the debtor generally will not recognize any gain or loss on the transfer.
- The debtor’s tax basis typically carries over to the acquiring company.

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Type G Requirements

- To qualify as a Type G reorganization, the transaction must fulfill several requirements:
  - Transfer must be pursuant to a court-approved plan adopted by both sides.
  - Transfer must be of “substantially all” of transferor's assets to a single acquiring corporation.
    - 50/70 rule—IRS guidelines in private letter rulings are that transferee must acquire more than 50% of fair market value of gross assets and more than 70% of the fair market value of operating assets of transferring company.

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Type G Requirements (cont.)

- Stock of acquirer must be distributed by transferring company to its shareholders.
- At least one shareholder of transferring company must receive stock of acquiring company.
- Must be a bona fide business or corporate purpose for transaction.
- Only the transferring corporation or the acquirer (or neither) can be an investment company.

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Type G Requirements (cont.)

- There must be a continuity of the business enterprise of transferor’s business.
  - This requirement is met if acquirer either continues transferor’s business or uses a significant portion of the transferor’s assets in acquirer's business.

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Tax Aspects of § 363 Asset Sales

- Continuity of proprietary interest requirement:
  - Measured by amount of stock received by transferor's creditors and shareholders as a percentage of total consideration.
  - Typically if 40% or more of consideration is transferor's stock, requirement is met.

Credit Bidding (363(K))

- When an asset is sold under 363 and it is subject to a secured creditor's lien, the creditor may use all or a portion of its claim against the debtor to satisfy the purchase price.
- This is known as credit bidding.
- This protects the secured creditor against bias from other parties that would undervalue the property.
- The creditors can also claim the proceeds from a 363 sale to another bidder if the creditor believes the bid represents the true value of the property.

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Credit Bidding (363(K))

- In theory, the creditor recognizes a taxable gain (or loss) equal to the difference between the fair market value of the property and the creditor's basis in the portion of the claim.
- In practice, however, there is a regulatory presumption that the fair market value of the property equals the amount of the claim exchanged for it, and thus no gain or loss is recognized.

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State Tax Considerations in § 363 Sales

- The transfer of assets in a § 363 sale may be subject to state and local transfer taxes.
- Transfers that occur pursuant to a confirmed reorganization plan or liquidation (under Bankruptcy Code §1146(a)) are exempt from certain transfer taxes.

State Tax Considerations in § 363 Sales

- However, this exemption has narrowed in recent years:
  - There is some question as to when federal bankruptcy law preempts state tax law.
  - It isn't certain exactly which state and local taxes are exempted from taxation by B.C. §1146(a).
  - The *Piccadilly* case in 2008: U.S. Supreme Court limited §1146(a) exemptions to "transfers made pursuant to a chapter 11 plan that has been confirmed."

Valuing Assets in Bankruptcy

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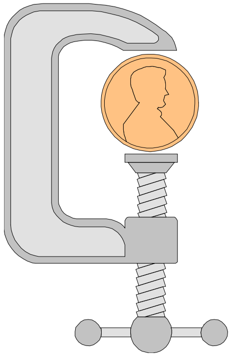

Valuing Assets in Bankruptcy

- Value assigned to debtor's assets is critically important in liquidations and reorganizations.
- Creditor claims are bifurcated into secured and unsecured status, depending on value assigned to underlying assets.
- Because secured creditors enjoy preferential treatment relative to unsecured creditors, and because many unsecured creditors receive little or nothing in the way of debt satisfaction, the value a court places on the debtor's assets often dictates whether, and in what amount, a creditor's claim will be paid.

Valuing Assets in Bankruptcy

- Valuation also plays a vital role in determining whether a secured creditor’s interest in the underlying collateral is adequately protected.

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Valuing Assets in Bankruptcy

- Unfortunately, there are at least two problems with the way courts currently address valuation issues in bankruptcy cases:
  - There are several methods available, but no guidelines indicating which method to apply in specific situations.
    - Consequently, courts in different jurisdictions inevitably apply different methods.
    - The same reorganization can have a decidedly different outcome in one jurisdiction than it would have in another.

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Valuing Assets in Bankruptcy

- The second problem arises in the context of chapter 11 and chapter 13 reorganizations. When repayments occur over time, the debtor must include interest in order to compensate creditor for—
    1. the time value of money, and
    2. the risk that the debtor might not complete all scheduled payments
- What is the appropriate level of interest?

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Valuing Assets in Bankruptcy

- Plans of reorganization under chapters 11 and 13 must provide secured creditors with an amount that is at least as much as the secured creditor would have received under that debtor's chapter 7 liquidation.
- When an evaluation of the debtor's assets is determined in this context, that evaluation should reflect what the market will pay for the assets as functioning components of the reorganized structure, not the value the assets would yield in a piecemeal fire sale.

1. Valuing Collateral in Chapter 13 Plans

- Three common methods of valuing assets:
  a. Replacement Value Method (AKA “retail” method).
  b. Wholesale Valuation Method (AKA “foreclosure”).
  c. Midpoint Valuation Method.

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Replacement Value Method

- Cost debtor would incur to replace collateral in question
- Based on second sentence of § 506(a) of Bankruptcy Code:
  - Value is to be determined "in light of the purpose of the valuation and of the proposed disposition or use of such property."
- Still ambiguous—SCOTUS case of *Associates Commercial Corp. v. Rash*, 520 U.S. 953 (1997) left to bankruptcy courts the decision of the "best way of ascertaining replacement value" (i.e., retail value, wholesale value, other alternatives).

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Wholesale Valuation Method

- Justice Stevens, dissenting in *Rash*, argued that foreclosure or wholesale method is correct method of valuing collateral in chapter 13.
- Based on first sentence of § 506(a), not second, leading Justice Stevens to hold that asset's value should be assessed from creditor's perspective, not debtor's.
- Critics of the wholesale valuation method argue that the first two sentences of § 506(a) are irreconcilable, and that because the debtor strives to retain collateral in question, the wholesale method ignores the second sentence of § 506(a), rendering the "disposition or use" language meaningless.

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Midpoint Valuation Method

- Just what it sounds like—midpoint between wholesale and retail.
- Some courts have held that the midpoint method is the most “equitable.”

2. Valuing Collateral in Chapter 11 Plans

- Three common methods of valuing assets:
  1. Comparable Company Analysis.
  2. Discounted Cash Flow Analysis.
  3. P/E Ratio Analysis.

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Comparable Company Analysis

- What constitutes a “comparable company” and who decides that?
- What should be compared?
  - Financial indicators? Which ones? What is close enough to be “comparable”?

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Questions?

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