Current Issues in Bankruptcy Taxation

Ray C. Schrock, Moderator
Weil Gotshal & Manges LLP

Hon. Kevin J. Carey
U.S. Bankruptcy Court (D. Del.); Wilmington

Steven J. Joffe
FTI Consulting, Inc.

Vadim Mahmoudov
Debevoise & Plimpton LLP

Alec P. Ostrow
Becker, Glynn, Muffly, Chassin & Hosinski LLP

Howard J. Tucker
EY

Bankruptcy Taxation Panel

ABI NYC Conference

May 14, 2015

Steven Joffe, *Senior Managing Director* – FTI Consulting Inc.

Vadim Mahmoudov, *Partner* – Debevoise & Plimpton LLP

Howard Tucker, *Partner* – Ernst & Young LLP

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Cancellation of Debt Income “COD”

Cancellation of Debt Income "COD"

- **Purposes of a Chapter 11 Reorganization**
  - Preserve value of debtor by remaining a going concern
  - Preserve jobs
- **Importance of Accurately Forecasting Future Tax Liability**
  - Taxes often are not a negligible expense
  - Impact of tax liability on disclosure statement projections
  - Impact of tax liability on feasibility analysis and liquidation analysis
- **Federal Income Tax Consequences of Chapter 11 Discharge**
  - COD excluded from income if it occurs "in a Title 11 case"
  - Tax attributes of the debtor may be reduced as a result of this COD exclusion

Cancellation of Debt Income "COD"

- **Background**
  - COD is generally income to the debtor
    - » IRC § 61(a)(12)
  - Various focused/narrowly circumscribed exceptions
    - » Payment would result in a deduction
    - » Purchase Price Adjustments
    - » Disputed Debt

Cancellation of Debt Income "COD"

- **General Rules**
  - Discharge of indebtedness is income to debtor
    - » IRC § 61(a)(12)
  - Principal exceptions
    - » IRC § 108(a)(1) – Gross income does not include any amount that would be includible in gross income by reason of the discharge of indebtedness *of the taxpayer* if –

      (A) the discharge occurs in a Title 11 case,

      (B) the discharge occurs when the debtor is insolvent

Cancellation of Debt Income "COD"

- **Treatment of Excluded COD**
  - If COD income is excluded from gross income then:
    - » COD is applied against and reduces debtor's tax attributes
    - » Any remaining COD income (*i.e.*, after exhausting all tax attributes) is not included in gross income, but instead disappears (so-called "black hole COD")

Cancellation of Debt Income "COD"

- **Limits on Attribute Reduction**
  - Bankrupt Debtor
    - » Attribute reduction rules apply to all debt that is discharged in bankruptcy
  - Insolvent Debtor
    - » Exclusion of COD and attribute reduction is limited to amount of insolvency
    - » If debt discharge results in debtor becoming solvent, excess amount of debt discharge is taxable COD income, subject to other potential exceptions

Cancellation of Debt Income "COD"

- **Order of Tax Attribute Reduction**
    1) **NOL and NOL carryovers**
    2) **General business credits**
        - » Includes investment credit, targeted jobs credit, alcohol fuels credit, research credit, and low income housing credit
        - » Reduced by $1 for every $3 of COD income
    3) **Minimum tax credits**
        - » Reduced by $1 for every $3 of COD income
    4) **Capital losses and capital loss carryovers**

Cancellation of Debt Income "COD"

- **Order of Tax Attribute Reduction (cont'd)**
  - **5) Basis of debtor's property**
    - » Order of basis reduction:
      - Trade/business or investment real property that secured debt (excludes IRC § 1221(a)(1) real property)
      - Trade/business or investment personal property that secured debt (excludes inventory, accounts receivable, and notes receivable)
      - Remaining trade/business or investment property (excludes IRC § 1221(a)(1) real property, inventory, accounts receivable, and notes receivable)
      - IRC § 1221(a)(1) real property, inventory, accounts receivable, and notes receivable
      - Property not used in trade/business or held for investment

Cancellation of Debt Income "COD"

- **Order of Tax Attribute Reduction (cont'd)**
  - **5) Basis of debtor's property (cont'd)**
    - » Basis reduction floor: undischarged liabilities
      - ▪ If all the liabilities are not discharged, basis reduction is limited to the amount of basis in excess of such liabilities
      - ▪ Upon later disposition of any property (even capital assets), any gain will be ordinary income, up to amount of basis reduced
  - **6) Passive activity losses and credit carryovers**
  - **7) Foreign tax credit carryovers**

Cancellation of Debt Income "COD"

- **COD of Members of Affiliated Group Filing Consolidated Returns**
  - Bankruptcy exception applies to each of the debtor entities
  - Insolvency exception applies debtor by debtor
- **Consolidated Return Attribute Reduction**
  - Methodology for group-wide attribution
    - » Debtor entity
    - » Look through
    - » Fan-out
  - Attributes of non-debtor companies can be reduced

Debt Exchanges

Debt Exchanges – Stock for Debt

- **Calculating COD**
  - If a company issues stock in exchange for outstanding debt, then the company will have COD income equal to the adjusted issue price ("AIP") of the debt less the fair market value of the stock issued in the exchange
  - AIP = issue price of debt instrument, increased by any original issue discount ("OID") previously includible in holder's gross income, and reduced by the amount of any payment previously made on the debt instrument other than a payment of qualified stated interest ("QSI")
  - QSI = stated interest at a fixed rate payable unconditionally at least annually
- **Example:**
  - Company has outstanding debt w/AIP $100 and Company transfers stock (FMV $90) to its creditors in exchange for the outstanding debt
  - Result: Company has $10 of COD income

Debt Exchanges – Debt for Debt

- **Non "Publicly Traded" Debt**
  - "Issue price" is stated principal amount, if neither the Old Debt nor New Debt is publicly traded and the New Debt pays interest of at least AFR (other than in "potentially abusive situations"). Policy rationale is that valuation is difficult if there is no public trading.
- **"Publicly Traded" Debt**
  - If either New Debt or Old Debt is deemed to be publicly traded for tax purposes within the period 15 days before & 15 days after the issue date then New Debt's AIP = FMV
    - » Executed sale, and sales price becomes reasonably available within reasonable period of time (TRACE, etc.)
    - » Firm quote available (price at which broker or dealer willing to buy or sell, even if not legally bound to do so)
    - » Indicative quote available (daily runs sent by dealers through Bloomberg, LSTA services)
  - Reasonable diligence required. Temporary restrictions may not be placed on trading to avoid the Publicly Traded rule, so the issuer is at risk for 15 days with no ability to control it
  - Small Issue Exception: if at the time of determination, both the New Debt and the Old Debt have an outstanding principal amount of $100 million or less, the debt is treated as not publicly traded

Debt Exchanges – Debt for Debt

- **Example**
  - Holder and Borrower agree to exchange New Debt of $1,000 principal amount bearing 5% interest for $1,000 principal of Old Debt. The FMV of New Debt is $700
  - If neither the New Debt nor the Old Debt is deemed to be publicly traded for tax purposes, the issue price of the New Debt will be $1,000 and there will be no COD
  - If within 15 days of the exchange, pricing information relating to transfers of the debt is reported on a quotation medium or is otherwise available, and the New Debt is trading at $700, then the issue price of the New Debt will be $700
    - » $300 of COD income to Borrower
    - » $300 of OID for Borrower and Holder (OID is the excess of the "stated redemption price at maturity" over the issue price)
  - Applicable High Yield Debt Obligation ("AHYDO") Rules
    - » >5 year term; yield in excess of AFR plus 5%; significant OID
    - » Disallow some or even all of the OID deductions (excess yield over AFR plus 6%). Defer any remaining OID deductions until payment of the OID
    - » Policy rationale is to limit or disallow deductions with respect to instruments that do not look like debt

Debt Exchanges – "Significant Modification" Resulting in Deemed Exchange

- Changes to the terms of the Old Debt which constitute a "significant modification" to the debt instrument will be treated as a deemed exchange of the Old Debt for the New Debt for tax purposes
- Same "significant modification" determination necessary for actual exchange
- Debt for Debt Exchange rules will apply; may result in COD
- Has there been a "modification"? If so, is the modification a "significant modification"?
  - Examples:
    - » Certain bright line rules:
      - Change in yield – greater of 25 basis points or 5% of annual yield
      - Change in timing of payments – lesser of 5 years or 50% of term
      - Change in obligor
    - » Modification results in instrument no longer being treated as debt for tax purposes (but ignore the financial deterioration of the debtor for this debt/equity determination)
    - » The addition, deletion or alteration of customary accounting or financial covenants are generally <u>not</u> significant modifications

Debt Exchanges of Distressed Debt – Holder's Perspective

- If Old Debt is distressed debt and there is an actual or deemed exchange of Old Debt, the holder would have gain or loss based on the difference between the issue price of the New Debt and the holder's basis in the Old Debt
  - As discussed above, if both Old Debt and New Debt are not "publicly traded" then issue price generally equals the face amount of New Debt
- The "face amount" rule may result in uneconomic taxable gain to the holder. (Even if issue price instead equals fair market value of New Debt, economic gain is possible for a holder who had bought Old Debt at a price below its current value.) Triggering taxable gain for the holder could be avoided if the exchange is treated as a tax-deferred recapitalization
- Recapitalization treatment could also help avoid triggering a capital loss followed by OID inclusions, which creates a character mismatch. Instead, newly created OID could be offset with bond premium deductions

Net Operating Loss Rules – Section 382

Net Operating Loss Rules – Section 382

- **Section 382 – Generally**
  - IRC § 382 generally provides that, after an "ownership change," the amount of a "loss corporation's" taxable income for any post-change year that may be offset by pre-change losses cannot exceed the "Section 382 limitation" for that year
    - » An ownership change is a greater than 50-percentage-point increase in ownership by "5% shareholders" during a "testing period," which is generally three years
  - A loss corporation is any corporation that has certain tax attributes, including NOL or capital loss carryforwards, credits, or built-in losses
  - The "Section 382 Limitation" consists of a "base limitation" and net unrealized built in gain ("NUBIG") recognized or "deemed recognized" under IRS pronouncements

Net Operating Loss Rules – Section 382

- **Computation of "Basic" Annual Limitation**
  - Equity value immediately before ownership change
    - » Less adjustments for
      - (1) Certain capital contributions within two years
      - (2) Redemptions and Corporate Contractions (*e.g.*, reduced by debt incurred by target in an acquisition)
      - (3) Certain non-business assets
    - » Equals adjusted equity value multiplied by the Tax Exempt Rate of interest for ownership changes in given month as promulgated by IRS
    - » Equals "basic" annual limitation
- **Built-in Gain**
  - Base limitation can be increased by NUBIG recognized or deemed recognized during the five year period after the ownership change

Net Operating Loss Rules – Section 382

- **Alternative Bankruptcy Limitation: Section 382(1)(5)**
  - Special bankruptcy rule IRC § 382(1)(5) applies if preexisting shareholders and "qualified" ("old and cold" or "trade") creditors of the loss corporation retain or receive 50% in vote and value of the reorganized corporation's stock in exchange for their stock or qualified debt
  - If IRC § 382(1)(5) applies then
    - » The normal Section 382 Limitation rules will not apply;
    - » Net operating losses are reduced by interest incurred on debt converted to equity/so-called "Interest haircut"
    - » If a subsequent ownership change occurs within two years – zero Section 382 Limitation
  - Can elect out of IRC § 382(I)(5)

Net Operating Loss Rules – Section 382

- **Section 382(1)(5) (cont'd)**
  - Trading restrictions or sell down orders on claims prior to the effective date to qualify for IRC § 382(1)(5)
  - Trading restrictions or sell down orders on stock after the effective date to avoid second ownership change within two years of emergence
  - NOLs are property of the bankruptcy estate
    - *Segal v. Rochelle*, 382 U.S. 375 (1966)
  - Extension of automatic stay protection to corporate NOLs
    - *Official Committee of Unsecured Creditors v. PSS Steamship Co.* (In re Prudential Lines, Inc.), 928 F.2d 565 (2d Cir. 1991), *cert. denied*, 112 S. Ct. 82 (1991)
  - Extension of *Prudential Lines* doctrine to trading restrictions on stock sales
    - *In re Phar Mar, Inc.*, 152 B.R. 924 (Bankr. N.D. Ohio 1993)
    - Sell down orders and qualification under IRC § 382(1)(5)

Net Operating Loss Rules – Section 382

- **Alternative Bankruptcy Limitation: Section 382(1)(6)**
  - Special bankruptcy rule IRC § 382(1)(6) applies where the conditions of IRC § 382(1)(5) are not satisfied or if debtor elects out of IRC § 382(1)(5)
  - If IRC § 382(1)(6) applies then
    - » The Section 382 Limitation is calculated by reference to equity value after restructuring

Built-In Gains/Losses

Built-In Gains/Losses

- **Background to the Built-In Gain/Loss Rules of Section 382(h)**
  - Built-in losses should be limited like NOLs
  - Built-in gains should enhance NOL utilization
  - If LossCo has a Net Unrealized Built-In Loss (NUBIL)
    - » Built-in losses recognized in five-year recognition period (RBIL) are treated as pre-change NOLs to extent of the NUBIL
  - If LossCo has a Net Unrealized Built-In Gain (NUBIG)
    - » Built-in gains recognized in recognition period (RBIG) increase the Section 382 limitation applicable to NOLs to the extent of the NUBIG

Built-In Gains/Losses

- **Notice 2003-65**
  - Under § 382(h)(6), items of income or deduction that are "attributable to" periods before change date are treated as RBIG/RBIL
  - Notice 2003-65 establishes two alternative approaches for identification of built-in items for purposes of § 382(h):
    - » The 1374 Approach, or
    - » The 338 Approach
  - Taxpayers permitted to rely on either approach pending issuance of regulations

Built-In Gains/Losses

- **Calculation of NUBIG/NUBIL**
  - Equals amount realized on hypothetical sale of all of corporation's assets at fair market value to purchaser who assumes all of its liabilities
  - Adjustments:
    - » Decreased by aggregate adjusted tax basis in corporation's assets
    - » Decreased by any deductible liabilities that would be included in amount realized on hypothetical sale
    - » Increased or decreased by any § 481 adjustments on hypothetical sale
    - » Increased by any RBIL not allowed as deduction under § 382, 383, or 384 on hypothetical sale

Built-In Gains/Losses

- **Notice 2003-65**
  - § 1374 Approach – Overview
    - » Identifies built-in items using § 1374 rules (net realized built-in gains of subchapter S corporations)
    - » Generally treats items as attributable to pre-change period if they accrue prior to ownership change
    - » Generally best for taxpayers who want to avoid characterization of deductions as built-in losses
  - § 338 Approach – Overview
    - » Identifies built-in items by comparing company's actual items with those that would have resulted from a § 338 transaction
    - » Generally allows some items (*e.g.*, income from foregone depreciation, deduction for contingent liabilities) not accrued prior to Ownership Change to be treated as built-in gain or loss
    - » Generally best for taxpayers who want to treat income from wasting assets as recognized built-in gain

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In re Charter Communications, Case No. 09-11435 (JMP) (Bankr. S.D.N.Y. 2009)

Preserving NOLs Through Settlements With Equity

Ray C. Schrock, P.C.

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Charter Communications – NOLs

- Key Players:
  - Paul Allen, Co-Founder of Microsoft, represented by Skadden
  - Debtors, represented by Kirkland & Ellis
  - Debtors' financial advisor, Lazard Frères & Co.
  - Bondholder sponsors (including Apollo), represented by Paul Weiss

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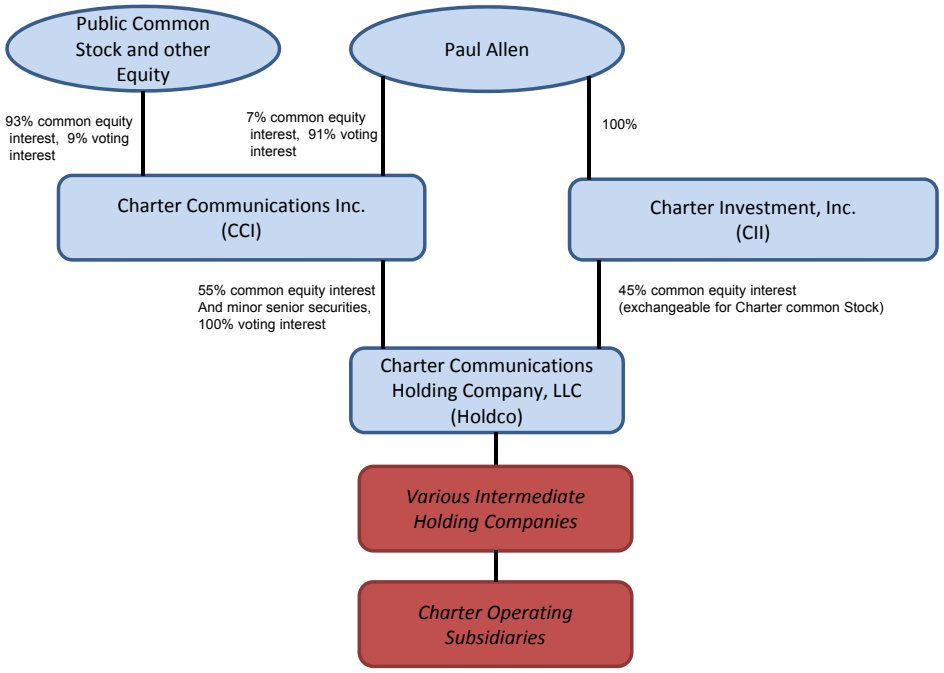
Charter Communications – Simplified Org Chart



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Charter Communications – NOLs

- Charter had run substantial operating losses as a tax matter for a number of years prior to its chapter 11 filing in March of 2009
- It was estimated that Charter had accumulated over $8.7 billion of net operating losses ("NOLs") as of December 31, 2008
- The preservation of a significant portion of Charter's NOLs after emerging from chapter 11 was contingent upon preserving the existing Holdco structure because of, among other things, certain cancellation of debt ("COD") income rules

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Charter Communications – NOLs

- The majority of the COD income generated from Charter's chapter 11 plan would have occurred at the Holdco (and its subsidiaries) level, which are generally disregarded entities for U.S. federal income tax purposes
- Therefore, the COD income would have been allocated to the two members of Holdco, CCI and CII, based on their respective percentage ownership interests in Holdco – approximately 55% to CCI and 45% to CII
- The allocation formula was one of the principal reasons for retaining the Holdco structure:
  - The allocation of COD income to CII would result in several billion dollars of NOL carryforwards being preserved at the CCI level
  - If Holdco were dissolved, all of the COD income could potentially be allocated to CCI, thereby eliminating most of CCI's NOL carryforwards

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Charter Communications – The Allen Settlement

- Charter could not have preserved the NOLs without Mr. Allen's cooperation
  - Allen agreed to forbear from exercising his prepetition exchange rights, in which he could have exchanged CII's 45% common equity in Holdco for CCI's common stock
  - Allen also agreed to retain a 1% equity ownership in Holdco
- If Allen did not agree to forbear from exercising his exchange rights and to keep the Holdco structure in place, approximately $6–7 billion of COD income associated with the restructuring would have been allocated to CCI and would have resulted in a reduction of Charter's NOLs dollar for dollar
- The settlement ensured that Mr. Allen and CII would continue as a partner of Holdco during and after the bankruptcy restructuring, thereby allotting approximately 45% of the debt cancellation to CII, resulting in the preservation of approximately $3 billion of NOLs for Charter
- Charter estimated that the settlement, by preserving approximately $3 billion in NOLs for CCI, would generate approximately $1 billion of future cash savings for Charter

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Charter Communications – The Allen Settlement

- Reinstatement of Senior Debt:
  - The transaction was structured so as not to trip the change of control event of default under the credit facility and various indentures.
    - The original credit agreement required that Allen retain a minimum voting percentage of 51% and that he own at least 25% of Charter's economic interests; however, the agreement was subsequently amended, reducing the minimum voting percentage to 35% and eliminating the requirement that Allen hold any economic interest in Charter.
    - Pursuant to the settlement, Allen agreed to give up his economic interest in Charter but retain a 35% voting interest, consistent with the change of control requirements under the credit facility.
  - This permitted Charter to reinstate its senior debt facility (approximately $12 billion) at the current favorable interest rates and avoid hundreds of millions of dollars in annual interest expense (*assuming Charter was even able to obtain replacement financing*)
    - In discussing the voting and economic requirements provision of the credit agreement, the court stated that the amended provision "almost invites smart lawyers to come up with a transaction or series of transactions to restructure Charter without tripping the covenant. Charter's advisors have managed to accomplish that objective."

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Charter Communications – The Allen Settlement

- The court examined the Allen settlement with "heightened scrutiny and some skepticism," and ultimately found that the Paul Allen settlement was "uniquely valuable to the Charter estate by establishing the grounds for reinstatement of the senior debt and for realizing potential tax savings [for Charter] that aggregate billions of dollars."

- This case illustrates how a potential debtor can work with existing stockholders and bondholders to generate substantial value in a restructuring by preserving NOLs while still allowing the new money investment bondholders enough control and substantial economic benefit to make the investment worthwhile.
  - In some cases, a sponsor's cooperation can be essential to reaching a deal that will preserve the NOLs, giving the sponsor significant leverage at the negotiating table.

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In re Washington Mutual, Inc., Case No. 08-12229 (MFW) (Bankr. D. Del. 2009)						

Preserving NOLs Through Worthless Stock Deductions

Ray C. Schrock, P.C.

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WaMu – Worthless Stock Deductions

- Key Players:
  - Debtors, represented by Weil, Gotshal & Manges
  - Federal Deposit Insurance Corporation, represented by DLA Piper
  - JPMorgan, represented by Sullivan & Cromwell
  - Creditors' Committee, represented by Akin Gump

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WaMu – Worthless Stock Deductions

- *WaMu* illustrates how a debtor can use a worthless stock deduction under a chapter 11 plan to maximize the value of the reorganized company
- Ultimate parent Washington Mutual, Inc. ("WMI") wholly owned Washington Mutual Bank ("WMB")
  - WMB was WMI's main operating subsidiary
  - On September 25, 2008, WMB was taken into receivership by FDIC and sold to JPMC
  - The next day, WMI filed for chapter 11 relief
- As a result of WMB's seizure and sale to JPMC, WMI incurred an approximately $5.5 billion loss in the value of its stock in WMB
- This stock loss formed the principal part of a $7.4 billion NOL that WMI could use in its restructuring

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WaMu – Worthless Stock Deductions

- WMI determined that its best option to preserve the NOL was to take a worthless stock deduction based on the loss in value of its stock in WMB
- WMI moved for and obtained an order prior to plan confirmation permitting it to abandon its stock in WMB
- On February 23, 2012, the Bankruptcy Court confirmed the debtors' chapter 11 plan
- Pursuant to the abandonment order and prior to the effective date, WMI took a worthless stock deduction for its stock in WMB, thereby recognizing its approximately $6.5 billion NOL
  - As a result of the ownership change on the effective date, the NOL was prorated between the pre- and post-effective-date portions of the year
  - Only the pre-effective-date portion was subject to an annual limitation resulting from the ownership change (about $6 million); the balance of the NOL (approx. $5.4 billion) was not subject to the annual limitation resulting from the ownership change

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WaMu – Worthless Stock Deductions

- Ordinary character of WMI's stock loss:
  - To generate an NOL, a stock loss has to be characterized as "ordinary" rather than "capital"
  - A stock loss is generally "ordinary" if more than 90% of the subsidiary's income over its life was active (rather than passive) income
  - Interest income—which was WMB's income—usually is not active income
  - So how was WMI able to characterize its stock loss as "ordinary"?
- WMI obtained a private letter ruling from the IRS:
  - Interest is the lifeblood of a bank's income, and so WMB's interest income was active
  - The fact that WMB was a bank was central to the IRS's ruling

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WaMu – Worthless Stock Deductions

- I.R.C. § 382 imposed restrictions on Reorganized WMI's business
  - Reorganized WMI needed to continue its historic business or use most of its historic business assets for at least two years following a change in control under its chapter 11 plan
  - If it did not do so, the value of its NOL was subject to reduction to zero
- Historically, WMI operated a wide variety of financial-services businesses, including insurance, retail banking, consumer lending, and broker-dealer services
- Reorganized WMI has continued its runoff mortgage reinsurance business and has preserved most of its NOL
  - KKR has subsequently acquired a minority stake in Reorganized WMI

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WaMu – Note on Tax Sharing Agreements

- Throughout its bankruptcy case, WMI's ability to retain its NOL was subject to significant litigation over, among other things, its entitlement to $5.5–5.8 billion in tax refunds
- WMI's ability to retain its NOL arose in part from a global settlement among the debtors, JPM, the FDIC, and the Creditors' Committee over parties' entitlement to tax refunds formerly owing to the consolidated WaMu tax group under a tax sharing agreement
  - JPM, the FDIC, and certain creditors asserted that WMI had acted as WMB's agent in filing tax returns for the consolidated WaMu group, and so any tax refunds attributable to WMB were to be held in trust by WMI for WMB's benefit
  - WMI asserted that the tax refunds were property of WMI's estate
  - The parties ultimately reached a global settlement that allocated WaMu's tax refunds
- Recently, the Third Circuit decided the issue that was settled in *WaMu*: whether a tax sharing agreement creates a trust relationship or a debtor-creditor relationship
  - Unless a TSA contains language mentioning the creation of a trust, the tax refund is property of the estate
  - *In re Downey Financial Corp.*, No. 14-1586 (3d Cir. Jan. 26, 2015)

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WaMu – Takeaways

- WaMu demonstrates several concepts:
  - Worthless stock deductions can be valuable alternative methods of preserving NOLs in bankruptcy . . .
  - . . . but the stock loss must be "ordinary"
  - IRS private letter rulings can reduce the execution risk of a deal
  - Tax sharing agreements can be a source of complex litigation in bankruptcy

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In re Residential Capital, LLC, Case No. 12-12020 (MG) (Bankr. S.D.N.Y. 2012)						

Bankruptcy Litigation Risks of Tax Sharing Agreements

Ray C. Schrock, P.C.

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ResCap – Tax Sharing Agreements

- Key Players:
  - Debtors, represented by Morrison Foerster
  - Ally Financial (f/k/a GMAC), represented by Kirkland & Ellis
  - Examiner Hon. Arthur J. Gonzales, represented by Chadbourne
  - Creditors' Committee, represented by Kramer Levin

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ResCap – Tax Sharing Agreements

- *ResCap* shows how prepetition tax sharing agreements within a consolidated group can constitute sources of litigation in bankruptcy
- Residential Capital, LLC ("ResCap") and its parent, Ally Financial Inc. ("AFI")—jointly owned by GM and Cerberus—entered into a series of tax sharing agreements beginning in 2005
- In 2009, ResCap and AFI entered into two subsequent tax sharing agreements
- After ResCap commenced its chapter 11 cases, the two 2009 tax sharing agreements became a particular focus of the ResCap Examiner's investigation

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ResCap – Tax Sharing Agreements

- The first 2009 tax sharing agreement was highly favorable to ResCap
- It required AFI to pay ResCap for ResCap's NOLs that were used by AFI – even if ResCap itself could not have used them on a stand-alone basis
  - AFI's authorized signatory signed the agreement
  - ResCap's board approved the agreement
  - But ResCap's authorized signatory did not sign the agreement
- AFI realized that it would have owed ResCap up to approximately $610 million under the agreement – something that AFI's board had not vetted
- The ResCap Examiner found that AFI subsequently pressured ResCap's authorized signatory not to sign the agreement, but that the agreement was nevertheless enforceable because ResCap's board had approved it (which was sufficient under Michigan law)

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ResCap – Tax Sharing Agreements

- ResCap's second 2009 tax sharing agreement was meant to supersede the first one
- This agreement removed AFI's obligation to pay ResCap for its tax attributes under any circumstances:
  - Even if ResCap earned profit and AFI was unable to use ResCap's tax attributes, ResCap still owed AFI the hypothetical stand-alone tax on ResCap's profit
  - ResCap was not entitled to tax refunds that it would have received if it were a stand-alone filer
  - Moreover, AFI billed ResCap for certain taxes incurred prior to the effective date of the agreement

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ResCap – Tax Sharing Agreements

- The ResCap Examiner determined that this tax sharing agreement could be avoided as a fraudulent transfer:
  - ResCap was insolvent when it entered into the second 2009 tax sharing agreement
  - ResCap did not receive reasonably equivalent value under this agreement
- The ResCap Examiner also considered:
  - (i) whether ResCap's board breached its fiduciary duties by approving the second 2009 tax sharing agreement, and
  - (ii) whether ResCap's authorized signatory breached his fiduciary duties by failing to execute the first 2009 tax sharing agreement
- The Examiner found that no breach occurred but that both cases were "close questions"

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ResCap – Tax Sharing Agreements

- The *ResCap* tax sharing agreements illustrate how prepetition tax sharing agreements – which are common among consolidated filing groups – can be sources of postpetition litigation:
  - Parties may challenge enforceability of tax sharing agreements
  - Fraudulent transfer risk
  - Fiduciary duty considerations
- In addition to involving sometimes sensitive business considerations among affiliates in a corporate group, tax sharing agreements may benefit from review by a restructuring professional to evaluate these risks

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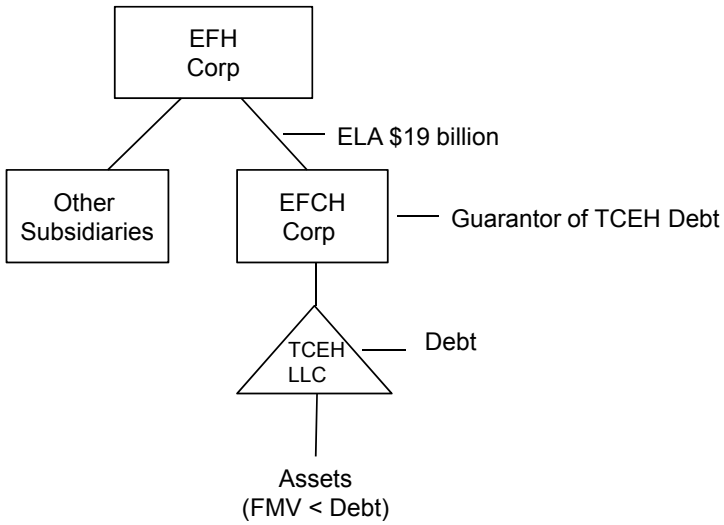
Energy Future Holdings case study
Excess loss account elimination – PLR 201326006



- TCEH LLC will need to undergo a debt restructuring and trigger significant COD income
- To the extent COD income is exempt under §108 and does not cause attribute reduction, ELA would be triggered. Reg. §1.1502-19(c)(1)(iii)(B).
- EFCH has no assets besides its membership interest in TCEH LLC.

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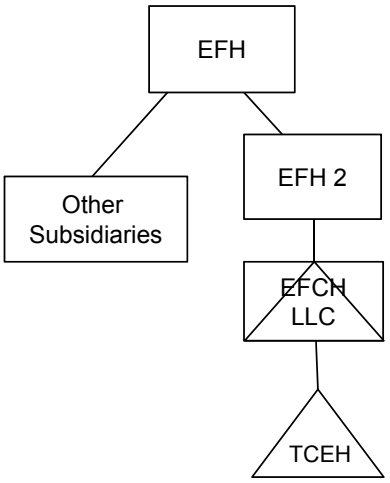
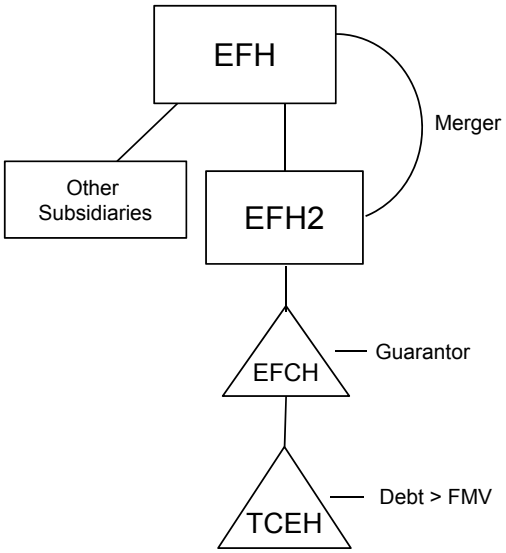
Step 1



- EFH contributes the stock of EFCH to a newly formed corporation, EFH2
- Immediately thereafter, EFCH converts into a LLC

1000479008v1

Step 2



- EFH merges downstream into EFH 2
- Taxpayer rep to IRS:
  Immediately after the Merger will be effective, the fair market value of the assets of EFH2 will exceed the amount of its liabilities.

1000479008v1

PLR 201326006 – Relevant Rulings

- Step 1 will qualify as a reorganization within the meaning of §368(a)(1)(F).
- Step 2 will qualify as a reorganization under § 368(a)(1)(A).
- The ELA will be eliminated without the recognition of gain as a result of the Merger. Treas. Reg. §1.1502-19(b)(2).

1000479008v1

928 F.2d 565
United States Court of Appeals,
Second Circuit.

In re PRUDENTIAL LINES INC., Debtor.
The OFFICIAL COMMITTEE OF UNSECURED CREDITORS
and Cold Spring Shipping, L.P., Appellees/Cross–Appellants,
v.
PSS STEAMSHIP COMPANY, INC., Appellant/Cross–Appellee.

Nos. 1023, 1131, Dockets 90–5063, 90–5073. | Argued Feb. 6, 1991. | Decided March 20, 1991.

On appeal from an order entered September 28, 1990, in the Southern District of New York, Robert P. Patterson, *District Judge,* affirming an order of the bankruptcy court that permanently enjoined appellant from taking a worthless stock deduction with respect to its bankrupt subsidiary, since that would have adversely affected the subsidiary's ability to carryforward its net operating loss (NOL) to offset future income, the Court of Appeals, Timbers, Circuit Judge, held: (1) that debtor's NOL carryforward was property of estate, and (2) that parent corporation's claiming of worthless stock deduction in stock of Chapter 11 debtor subsidiary, which would effectively eliminate value of debtor's NOL carryforward, would be an act to exercise control over estate property in violation of automatic stay.

Affirmed.

West Headnotes (8)

[1] **Bankruptcy** Tax Refunds, Credits, and Deductions

Net operating loss (NOL) carryforward attributable to Chapter 11 debtor subsidiary, attributable to debtor's prebankruptcy operation, was property of Chapter 11 estate, despite debtor's status as affiliated corporation filing consolidated tax return along with its parent and other affiliated corporations; there was no explicit agreement between debtor and parent as to allocation of NOL. Bankr.Code, 11 U.S.C.A. §§ 541, 541(a)(1); 26 U.S.C.A. §§ 1501–1504.

29 Cases that cite this headnote

[2] **Bankruptcy** Effect of State Law in General

Nature and extent of debtor's interests in property is determined by applicable nonbankruptcy law, but whether that interest is included in property of debtor's estate is determined by bankruptcy law. Bankr.Code, 11 U.S.C.A. § 541(a)(1).

38 Cases that cite this headnote

[3] **Internal Revenue** Corporations Permitted to File Consolidated Returns

Filing of bankruptcy petition by one member of affiliated group of corporations does not mandate deconsolidation of group, for purposes of filing federal tax return. 26 U.S.C.A. §§ 1501–1504.

7 Cases that cite this headnote

[4] **Internal Revenue** Tax Liability of Affiliates; Apportionment

Fact that subsidiary's net operating loss (NOL) ultimately may be used to offset another corporation's income does not mean that subsidiary loses any interest in its NOL; parent acts as agent on behalf of all members of consolidated group for convenience and protection of the Internal Revenue Service (IRS) only, corporations retain their separate identities, and property interests of subsidiaries are not absorbed by common parent. 26 U.S.C.A. §§ 1501–1504.

14 Cases that cite this headnote

[5] **Bankruptcy** Particular Items and Interests

Interests whose value is speculative and interests that involve tangible rights that are subject to regulation may be included in property of estate. Bankr.Code, 11 U.S.C.A. § 541.

3 Cases that cite this headnote

[6] **Bankruptcy** Tax Refunds, Credits, and Deductions

Bankruptcy Code provision that estate succeeds to tax attributes of individual debtor including any loss carryover does not apply to corporate debtors, but, since bankruptcy estate of corporate debtor is not separate entity for tax purposes, there was no need for Congress to provide that carryovers are transferred to estate and then back to corporate debtor at conclusion of estate. Bankr.Code, 11 U.S.C.A. § 346(c)(1), (i).

13 Cases that cite this headnote

[7] **Bankruptcy** Proceedings, Acts, or Persons Affected

Parent corporation's claiming of worthless stock deduction in stock of Chapter 11 debtor subsidiary, which would effectively eliminate value of debtor's net operating loss (NOL) carryforward, would be act to exercise control over estate property in violation of automatic stay. Bankr.Code, 11 U.S.C.A. § 362(a)(3); 26 U.S.C.A. §§ 382, 382(b), (e)(1), (g)(4)(D).

36 Cases that cite this headnote

[8] **Bankruptcy** Injunction or Stay of Other Proceedings

Bankruptcy court's equitable powers granted under the Bankruptcy Code gave it authority to enter permanent injunction against parent corporation's claiming of worthless stock deduction in stock of Chapter 11 debtor subsidiary, which would eliminate debtor's net operating loss carryforward, and such injunction was not impermissible adjudication of tax liability of parent, a nondebtor. Bankr.Code, 11 U.S.C.A. §§ 105(a), 505(a)(1).

20 Cases that cite this headnote

Attorneys and Law Firms

***566** W. Bruce Johnson, New York City (Richard O'Toole, Joanne Wilson, and Battle Fowler, New York City, on the brief), for appellant, cross-appellee PSS S.S. Co., Inc.

Max O. Truitt, Jr., Washington, D.C. (Wilmer, Cutler & Pickering, Washington, D.C., Allan L. Gropper, and White & Case, New York City, on the brief), for appellees, cross-appellants Cold Spring Shipping, L.P. and The Official Committee of Unsecured Creditors.

Before TIMBERS, NEWMAN and ALTIMARI, Circuit Judges.

Opinion

TIMBERS, Circuit Judge:

Appellant/cross-appellee PSS Steamship Company, Inc. (PSS) appeals from an order entered September 28, 1990, in the Southern District of New York, Robert P. Patterson, *District Judge*, affirming an order of the bankruptcy court that permanently enjoined it from taking a worthless stock deduction on its 1988 federal income tax return with respect to its bankrupt subsidiary Prudential Lines, Inc. (PLI), since that would have adversely affected PLI's ability to carryforward its net operating loss (NOL) to offset future income.

On appeal, PSS contends that (1) the NOL generated by PLI was not property of PLI's estate within the meaning of § 541 of the Bankruptcy Code; and (2) the bankruptcy court erred in enjoining PSS from taking a worthless stock deduction on its 1988 federal income tax return as violative of the automatic stay. On cross-appeal, the Official Committee of Unsecured Creditors (Creditors' Committee) and Cold Spring Shipping, L.P. (Cold Spring) contend that the bankruptcy court erred in denying relief based on a violation of PSS' fiduciary duty to PLI.

Since we agree with Judge Patterson's excellent district court opinion and for the reasons that follow, we affirm the judgment of the district court.

I.

We shall summarize only those facts and prior proceedings believed necessary to an understanding of the issues raised on appeal.

At all times relevant to this appeal, PLI was a wholly owned subsidiary of PSS that provided United States flag shipping between ports in Europe and the Black Sea. Spyros S. Skouras, Sr. is chief executive ***567** officer and a director of PSS, and was Chairman and President of PLI until his resignation in November 1989. Spyros S. Skouras, Jr. was Vice President, General Manager, and a director of PLI. In addition, Skouras, Jr. has participated in the financial and tax affairs of PSS since 1986. In that capacity, he consults with PSS' tax counsel and accountants and relays information to his father.

PSS and PLI, along with two other affiliated entities have filed consolidated tax returns since 1976 pursuant to 26 U.S.C. § 1501 *et seq*. (1988). In 1988, these entities had a combined NOL of $75 million available to be offset against income. Of that amount, $74 million was attributable to PLI's pre-bankruptcy operations. NOLs are tax deductible and may be carried back and applied against income in previous years (carryback), or carried forward and applied against income in subsequent years (carryforward). 26 U.S.C. § 172 (1988).

On September 12, 1986, an involuntary petition for reorganization under Chapter 11 of the Bankruptcy Code was filed against PLI. Soon thereafter, PLI consented to an order for relief. The Creditors' Committee was appointed pursuant to 11 U.S.C. § 1102 (1988) to represent the interests of PLI's unsecured creditors. Cold Spring purchased a participation interest in the unsecured claim of the United States Maritime Administration (MARAD).

In the summer of 1988, Skouras, Sr. and Skouras, Jr. began to formulate a plan for reorganization on behalf of PLI (the “PLI plan”). In connection with that plan, they prepared a term sheet dated August 4, 1988, which indicated that, under the PLI plan,

the Skouras family would retain control of PLI and a NOL carryforward of $74 million would be available to offset future income of the reorganized company.

In February 1989, PSS was informed by tax counsel and by its accountants that it could take a $38.9 million worthless stock deduction in connection with its PLI stock on its 1988 federal income tax return. If PSS took that action, it would effectively eliminate the value of the NOL to PLI. Later that month, PLI filed a plan for reorganization with the bankruptcy court. Under that plan, Skouras, Jr. would retain a 75 percent interest in the reorganized company and serve as President. Skouras, Sr. would serve as Chairman of the reorganized company. The disclosure statement accompanying the PLI plan contemplated the availability of PLI's NOL to offset future income of the reorganized company.

In July 1989, PSS' accountants prepared a draft federal income tax return for 1988 that reflected a worthless stock deduction in connection with the PLI stock. The following month PLI filed an amended plan of reorganization. The disclosure statement accompanying the amended PLI plan still reflected the availability of the NOL carryforward to the reorganized company. It did not mention the possibility of PSS taking a worthless stock deduction on its 1988 federal income tax return.

The PLI plan failed to win the support of the creditors. On September 11, 1989, the Creditors' Committee and Cold Spring filed a draft of a joint plan for reorganization (creditors' plan). That plan provided for new management of the reorganized company and provided for no distributions to the Skouras family. The PLI stock owned by the Skouras family was to be cancelled. Like PLI's plan, it also contemplated a carryforward of PLI's $74 million NOL. In an objection to this plan, filed September 19, 1989, PSS announced for the first time its intention to take a worthless stock deduction in the amount of $38.9 million in connection with its PLI stock on its 1988 tax return.

Skouras, Jr. attended three meetings with officials of MARAD, the unsecured creditor holding the largest single claim against PLI, to urge them to support the PLI plan and reject the creditors' plan. At one of these meetings, Skouras, Jr. provided MARAD with a written comparison of the two plans that described the NOL as preserved under the PLI plan and uncertain under the creditors' plan. Skouras, Jr. informed MARAD that PSS might take a worthless stock deduction on its 1988 tax return, which would limit any NOL available to a reorganized PLI.

***568** On October 10, 1989, counsel for PLI met with counsel for the Creditors' Committee and Cold Spring. At that meeting counsel for PLI broached the subject of personal releases in favor of Skouras, Sr. and Skouras, Jr. in the event the creditors' plan was confirmed. The Creditors' Committee and Cold Spring sought assurances that PSS would not take the worthless stock deduction. PSS agreed, subject to revocation by written notice, that it would not take the deduction while negotiations continued.

On November 6, 1989, after the negotiations failed, PSS informed Cold Spring by letter that it reserved the right to take the worthless stock deduction. On the following day Skouras, Jr. met with officials at MARAD and presented them with a copy of the letter. He told them that he did not know whether PSS actually intended to take the worthless stock deduction on its 1988 federal income tax return.

PLI rejected the request of the Creditors' Committee and Cold Spring to take steps to prevent PSS from taking the worthless stock deduction. Skouras, Sr. resigned from his positions with PLI, effective November 3, 1989, after PSS decided to take the worthless stock deduction on its 1988 tax return.

On November 13, 1989, the Creditors' Committee and Cold Spring commenced an adversary proceeding in the bankruptcy court seeking to have PSS preliminarily and permanently enjoined from taking the worthless stock deduction on its 1988 tax return. Count one of the complaint alleged that taking the worthless stock deduction on its 1988 tax return would amount to a breach of PSS' fiduciary duty to PLI. Count two alleged that PSS was using the threat of the worthless stock deduction only to interfere with the creditors' plan to reorganize PLI. Count three alleged that the NOL attributable to PLI was property of PLI's bankruptcy estate and that taking the worthless stock deduction would violate the automatic stay provision of the Bankruptcy Code.

On November 21, 1989, the bankruptcy court held a hearing on plaintiffs' motion for a preliminary injunction. At the conclusion of the hearing, the bankruptcy court denied relief on counts one and two, holding that there was a legitimate business purpose for taking the worthless stock deduction and that the business judgment rule precluded further review of the propriety of that decision. On December 4, 1989, the bankruptcy court granted preliminary injunctive relief on count three. *Official Committee of Unsecured Creditors v. PSS S.S. Co., Inc. (In re Prudential Lines, Inc.),* 107 B.R. 832 (Bankr.S.D.N.Y.1989). The bankruptcy court held that the NOL generated by PLI was property of PLI's bankruptcy estate and that the worthless stock deduction was an attempt to exercise control over that property in violation of the automatic stay. On December 19, 1989, the bankruptcy court permanently enjoined PSS from taking the worthless stock deduction on its 1988 tax return. *Official Committee of Unsecured Creditors v. PSS S.S. Co., Inc. (In re Prudential Lines, Inc.),* 114 B.R. 27 (Bankr.S.D.N.Y.1989). The creditors' plan for reorganization was confirmed on December 15, 1989. PSS has not yet filed its 1988 tax return.

PSS appealed from the decision of the bankruptcy court to the district court pursuant to 28 U.S.C. § 158(a) (1988). The Creditors' Committee and Cold Spring cross-appealed from the bankruptcy court's denial of the injunction on counts one and two. On September 28, 1990, the district court affirmed the judgment of the bankruptcy court. *Official Committee of Unsecured Creditors v. PSS S.S. Co., Inc. (In re Prudential Lines, Inc.),* 119 B.R. 430 (S.D.N.Y.1990). The district court denied the cross-appeal without prejudice.

This appeal followed.

II.

Initially, we set forth our standard of review. Our review of the district court order is plenary. *Gulf States Exploration Co. v. Manville Forest Prods. Corp. (In re Manville Forest Prods. Corp.),* 896 F.2d 1384, 1388 (2 Cir.1990); *Brown v. Pennsylvania State Employees Credit Union,* 851 F.2d 81, 84 (3 Cir.1988). "This court exercises ***569** the same review over the district court's decision that the district court may exercise [over the bankruptcy court's decision]." *Brown, supra,* 851 F.2d at 84. Accordingly, we will accept the bankruptcy court's findings of fact unless clearly erroneous. *In re Manville Forest Prods., supra,* 896 F.2d at 1388; Bankr. Rule 8013. We review the bankruptcy court's legal conclusions *de novo. In re Manville Forest Prods., supra,* 896 F.2d at 1388.

III.

[1] With the foregoing in mind, we turn first to PSS' contention that the NOL attributable to PLI does not constitute property of PLI's bankruptcy estate within the meaning of § 541 of the Bankruptcy Code. PSS contends that the law of consolidated tax returns gives it, and not PLI, the right to use PLI's NOL to offset income. PSS contends that the right to the NOL carryforward is not PLI's property and cannot be considered property of PLI's estate. We disagree.

Our inquiry begins with the definition of property of the estate set forth in the Bankruptcy Code. Property of the estate encompasses "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(a)(1) (1988). In construing this section, we are mindful that Congress intended § 541 to be interpreted broadly. *United States v. Whiting Pools, Inc.,* 462 U.S. 198, 204, 103 S.Ct. 2309, 2313, 76 L.Ed.2d 515 (1983). To facilitate reorganization, it is vital to include all the debtor's property in its bankruptcy estate. *Id.* at 203, 103 S.Ct. at 2312.

[2] The nature and extent of the debtor's interest in property is determined by applicable non-bankruptcy law. *Crysen/Montenay Energy Co. v. Esselen Assocs., Inc. (In re Crysen/Montenay Energy Co.),* 902 F.2d 1098, 1101 (2 Cir.1990); *Sanyo Elec., Inc. v. Howard's Appliance Corp. (In re Howard's Appliance Corp.),* 874 F.2d 88, 93 (2 Cir.1989). Whether that interest is included in the property of the debtor's estate is determined by bankruptcy law. *In re Crysen/Montenay, supra,* 902 F.2d at 1101; *Coben v. Lebrun (In re Golden Plan of California, Inc.),* 37 B.R. 167, 169 (Bankr.E.D.Cal.1984).

(A)

We turn next to PSS' contention that PLI's status as an affiliated corporation filing a consolidated tax return abolished any interest it had in the right to use its NOL to offset its income. We disagree.

[3] Affiliated corporations that meet certain criteria are entitled to file a consolidated tax return. 26 U.S.C. §§ 1501–04 (1988). Such returns are filed in the name of the "common parent", who acts as the agent for each subsidiary in the group and acts on behalf of the group in all matters related to tax liability for the consolidated group. 26 C.F.R. § 1.1502–77(a) (1990). A corporation must consent to the filing of a consolidated return on its behalf. 26 C.F.R. § 1.1502–75(b) (1990). Once consent is given, an affiliated group must obtain the permission of the IRS to deconsolidate. *Koscot Interplanetary, Inc. v. Glenn Turner Enters., Inc. (In re Koscot Interplanetary, Inc.),* 76–1 U.S. Tax Cas. (CCH) ¶ 9442, at 84,188, 1976 WL 1029 (M.D.Fla.1976); 26 C.F.R. § 1.1502–75(c) (1990). The filing of a bankruptcy petition by one of the members of the group does not mandate a deconsolidation of the group. *In re Koscot, supra,* at 84,187.

"Those [corporations that] file consolidated returns are 'treated as a single entity for income tax purposes as if they were, in fact, one corporation.' " *Exxon Corp. v. United States,* 785 F.2d 277, 280 (Fed.Cir.1986) (citation omitted); *see also International Tel. & Tel. Corp. v. United States,* 608 F.2d 462, 474, 221 Ct.Cl. 442 (Cl.Ct.1979) ("[a] consolidated group of corporations filing a consolidated return is considered a single taxpayer"); *American Standard, Inc. v. United States,* 602 F.2d 256, 261, 220 Ct.Cl. 411 (Cl.Ct.1979) ("purpose behind allowing corporations to file consolidated returns is to permit affiliated corporations, which may be separately incorporated for various business reasons, to be treated as a single entity for income tax purposes as if they were, in fact, one corporation"). Accordingly, NOLs of the affiliated corporations may be aggregated and ***570** applied against the consolidated income of the group. 26 C.F.R. § 1.1502–21 (1990).

In the instant case, PSS and PLI, along with two other affiliated corporations, have filed a consolidated tax return since 1976. Although the confirmation of the reorganization plan and the concomitant change in ownership of PLI will cause PLI's departure from the group, the corporations were still consolidated for tax purposes in the tax year in question. PSS contends that since PLI was a member of a group that filed a consolidated tax return, the common parent, not PLI, controlled the manner in which PLI's NOL would be applied against income of the group members. PSS contends, therefore, that the right to the NOL carryforward was not PLI's property at the commencement of the bankruptcy case.

In support of its position, PSS relies on a series of cases that stand for the proposition that one member of an affiliated group does not have to compensate another member for tax benefits accruing to it through the use of the other member's NOL. *E.g., Western Pac. R.R. Corp. v. Western Pac. R.R. Co.,* 197 F.2d 994, 1004 (9 Cir.1951), *rev'd on other grounds,* 345 U.S. 247, 73 S.Ct. 656, 97 L.Ed. 986 (1953); *In re Coral Petroleum, Inc.,* 60 B.R. 377, 389 (Bankr.S.D.Tex.1986); *In re All Products Co.,* 32 B.R. 811, 814 (Bankr.E.D.Mich.1983); *M & M Transp. Co. v. U.S. Indus., Inc.,* 416 F.Supp. 865, 869 (S.D.N.Y.1976); *Meyerson v. El Paso Natural Gas Co.,* 246 A.2d 789, 791–94 (Del.Ch.1967); *Case v. New York Cent. R.R. Co.,* 15 N.Y.2d 150, 158, 204 N.E.2d 643, 647, 256 N.Y.S.2d 607, 612 (1965). That reliance is misplaced.

The above cases were decided under fiduciary duty and contract standards. *Western Pac., supra,* 197 F.2d at 999 (bankrupt subsidiary did not breach fiduciary duty by using parent's NOL to offset its income); *In re Coral Petroleum, supra,* 60 B.R. at 390–91 (corporate debtor did not have fiduciary duty to compensate subsidiary for use of its NOL to offset income of other subsidiaries on consolidated return and was not unjustly enriched by that action); *In re All Prods. Co., supra,* 32 B.R. at 813–15 (bankrupt subsidiary could not reduce parent's claim by amount that parent's tax liability was diminished through use of subsidiary's NOL on consolidated return); *M & M Transp. Co., supra,* 416 F.Supp. at 869 (former subsidiary seeking compensation from former parent for use of NOL on consolidated return that resulted in tax refund); *Meyerson, supra,* 246 A.2d at 791–94 (parent did not breach fiduciary duty by using subsidiary's NOL to offset its income on consolidated return); *Case, supra,* 15 N.Y.2d at 154–55, 204 N.E.2d at 644–45, 256 N.Y.S.2d at 608–09 (action to rescind agreement among affiliated

corporations regarding the allocation of federal tax liability on consolidated return). As such they are more appropriate to the issues raised by the cross-appeal. Moreover, although some of these cases involved bankrupt corporations, none purported to determine whether the NOL attributable to the bankrupt corporation was property of that corporation's bankruptcy estate.

Only *In re All Prods. Co.* involved a parent corporation's use of its bankrupt subsidiary's NOL to offset its income. In that case, the tax savings occurred prior to the filing of the bankruptcy petition, 32 B.R. at 813, and the court did not consider the issue of whether the NOL attributable to the debtor at the time of the filing of the bankruptcy petition was property of its bankruptcy estate. Moreover, the court in that case found implied consent on the part of the subsidiary to the use of its NOL to offset the parent's income. *Id.* at 814–15. It is not disputed that "where there is an explicit agreement, or where an agreement can fairly be implied, as a matter of state corporation law the parties are free to adjust among themselves the ultimate tax liability." *Western Dealer Management, Inc. v. England (In re Bob Richards Chrysler–Plymouth Corp., Inc.),* 473 F.2d 262, 264 (9 Cir.), *cert. denied,* 412 U.S. 919, 93 S.Ct. 2735, 37 L.Ed.2d 145 (1973) (footnotes omitted). However, "consent[ ] to the filing of a consolidated tax return ... cannot be construed to include the transfer of a valuable asset without further consideration." *In re Bob Richards, supra,* 473 F.2d at 264. There was no explicit agreement between PSS and ***571** PLI as to the allocation of PLI's NOL. We discern no such implied agreement.

[4] The fact that a subsidiary's NOL ultimately may be used to offset another corporation's income does not mean that the subsidiary loses any interest in its NOL. The common parent acts as an agent on behalf of all the members of the consolidated group "for the convenience and protection of [the] IRS only." *Jump v. Manchester Life & Casualty Management Corp.,* 579 F.2d 449, 452 (8 Cir.1978); *accord In re Bob Richards, supra,* 473 F.2d at 265. The corporations retain their separate identities and the property interests of the subsidiaries are not absorbed by the common parent. *Wolter Constr. Co., Inc. v. Commissioner,* 634 F.2d 1029, 1038 (6 Cir.1980). It follows that a corporation does not lose any interest it had in the right to use its NOL to offset income because of its status in a group of affiliated corporations that file a consolidated tax return. *E.g.,* 26 C.F.R. § 1.1502–79(a)(1)(ii) (1990) (upon deconsolidation any remaining NOL attributable to a corporation is available to offset income on its separate tax returns); *see also In re Bob Richards, supra,* 473 F.2d at 265 ("[a]llowing the parent to keep any refunds arising solely from a subsidiary's losses simply because the parent and subsidiary chose a procedural device to facilitate their income tax reporting unjustly enriches the parent").

We hold that at the commencement of the bankruptcy case against it, PLI had an interest in the $74 million NOL attributable to its pre-bankruptcy operation.

(B)

This brings us to the question whether PLI's interest in the right to carryforward its $74 million NOL to offset future income is property of the estate within the meaning of § 541. We hold that it is.

In *Segal v. Rochelle,* 382 U.S. 375, 86 S.Ct. 511, 15 L.Ed.2d 428 (1966) (Harlan, J.), the Supreme Court, construing § 541's predecessor, considered whether a NOL carryback that resulted in a tax refund to an individual debtor was property of that debtor's estate. The Court held that a NOL carryback was property of an individual debtor's estate. *Id.* at 380, 86 S.Ct. at 515. Recognizing the "conceptual[ ] as well as practical [ ]" differences between carrybacks and carryforwards, the Court declined to decide the issue of whether NOL carryforwards were also property of the estate. *Id.* at 381, 86 S.Ct. at 515. It expressed concern that including NOL carryforwards as property of the estate of an individual debtor could endanger the fresh start policy of the Bankruptcy Act by forcing the estate to remain open for a long period. *Id.*

The legislative history of § 541 demonstrates that Congress agreed with the result reached by the *Segal* Court.

> "[T]he estate is comprised of all legal or equitable interest of the debtor in property, wherever located, as of the commencement of the case. The scope of this paragraph is broad. It includes all kinds of property,

> including tangible or intangible property, causes of action ... and all other forms of property currently specified in [the predecessor statute to § 541]. ... The result of *Segal v. Rochelle,* 382 U.S. 375 [86 S.Ct. 511, 15 L.Ed.2d 428] (1966), is followed, and the right to a refund is property of the estate."

S.Rep. No. 95–989, 95th Cong. 2d Sess. 82, *reprinted in* 1978 U.S.Code Cong. & Admin.News 5787, 5868; H.R.Rep. No. 95–595, 95th Cong. 1st Sess. 367, *reprinted in* 1978 U.S.Code Cong. & Admin.News 5963, 6323 (footnote omitted).

Courts, applying *Segal,* have held that a subsidiary is entitled to a tax refund due to its NOL carryback to the extent that it offsets its own income. *E.g., Jump, supra,* 579 F.2d at 452; *In re Bob Richards, supra,* 473 F.2d at 264; *In re Revco D.S., Inc.,* 111 B.R. 631, 639 (Bankr.N.D.Ohio 1990). Courts considering whether NOL carryforwards constitute property of the estate have reached varying conclusions in varying contexts. *Compare Jump, supra,* 579 F.2d at 453 ("the right to use its net operating loss to gain carryover tax advantage was not an asset of [a liquidating subsidiary] because its value was conditioned on the existence of future income potential of [the subsidiary]") *and Davis v. Commissioner,* 69 T.C. 814, 827 (1978) ***572** ("net operating loss carryover cannot constitute property" of an individual debtor's estate) *with In re Beery,* 116 B.R. 808, 810 (D.Kan.1990) (right to use NOL carryforward is property of debtor's estate).

PSS contends that *Segal* does not control the instant case since it involved a NOL carryback rather than a NOL carryforward, and an individual rather than a corporate debtor filing a consolidated return. Those distinctions do not require a contrary result here.

[5] Carryforwards differ in nature from carrybacks. Carrybacks result in the right to a tax refund of a definite amount. Carryforwards, by contrast, are speculative since their value depends on the availability of future income against which to apply them. The speculative nature of carryforwards does not place them outside the definition of property of the estate. "[T]he term 'property' has been construed most generously and an interest is not outside its reach because it is novel or contingent or because enjoyment must be postponed." *Segal, supra,* 382 U.S. at 379, 86 S.Ct. at 515; *see also* H.R.Rep. No. 95–595, 95th Cong., 2d Sess. 175–76, *reprinted in* 1978 U.S.Code Cong. & Admin.News 5963, 6136 (property of the estate "includes all interests, such as ... contingent interests and future interests, whether or not transferable by the debtor"). The fact that the right to a NOL carryforward is intangible and has not yet been reduced to a tax refund also does not exclude it from the definition of property of the estate. *In re Golden Plan, supra,* 37 B.R. at 169. In short, interests whose value is speculative and interests that involve intangible rights that are subject to regulation may be included as property of the estate. *E.g., Neuton v. Danning (In re Neuton),* 922 F.2d 1379, 1382–83 (9 Cir.1990) (interest in trust contingent on survivorship is property of the estate); *Tringali v. Hathaway Mach. Co.,* 796 F.2d 553, 560 (1 Cir.1986) (liability insurance policy is property of the estate); *Beker Indus. Corp. v. Florida Land & Water Adjudicatory Comm'n (In re Beker Indus. Corp.),* 57 B.R. 611, 622 (Bankr.S.D.N.Y.1986) (right to truck products from mine is property of estate); *In re Golden Plan, supra,* 37 B.R. at 169 (corporate name is property of the estate). Thus, the nature of the interest involved in the instant case does not compel a conclusion that it is not property of the estate.

As the *Segal* Court observed, the main hurdle to including NOL carryforwards as property of the estate is the detrimental impact it could have on the fresh start policy that is promoted by the Bankruptcy Code. *Segal, supra,* 382 U.S. at 381, 86 S.Ct. at 515. Subsequent legislation has ameliorated that concern with respect to individual debtors and suggests that Congress intended that NOL carryforwards be included in the property of the estate of individual as well as corporate debtors.

[6] Congress provided for the tax treatment of debtors and their bankruptcy estates in § 346 of the Bankruptcy Code. With respect to individual debtors, Congress provided that the income to their estates could be taxed separately from the income to the individual debtor. 11 U.S.C. § 346(b)(1) (1988). Congress also provided that the estate succeeds to the tax attributes of individual debtors including "any loss carryover." 11 U.S.C. § 346(i)(1)(C) (1988). To address the *Segal* Court's concern that including carryforwards as property of the estate would jeopardize the fresh start policy, Congress provided that unutilized tax attributes revert to the debtor at the conclusion of the case. 11 U.S.C. § 346(i)(2) (1988). Section 346(i) seems to contemplate that NOL carryforwards, as well as carrybacks, become property of an individual debtor's bankruptcy estate. Other subsections contemplate use of NOL carryforwards by a corporate debtor. *E.g.,* 11 U.S.C. § 346(h) (1988) (determination of periods in which debtor may use NOL carryover); 346(j)(3) (NOL carryover of individual or corporate debtor is reduced by the amount of debt forgiven or discharged).

We do not read § 346(i) as applying to corporate debtors. *E.g., Maritime Asbestosis Legal Clinic v. LTV Steel Co., Inc. (In re Chateaugay Corp.),* 920 F.2d 183, 187 (2 Cir.1990) (section permitting individual debtors to recover sanctions for willful ***573** violations of automatic stay cannot be read to apply to corporate debtors). Congress' failure to include corporate debtors in that provision does not imply, however, that Congress meant to treat NOL carryforwards of corporate debtors differently than those of individual debtors. Since the bankruptcy estate of a corporate debtor is not a separate entity for tax purposes, 11 U.S.C. § 346(c)(1) (1988), there was no need for Congress to provide that carryovers are transferred to the estate and then back to the corporate debtor at the conclusion of the case.

Corporations attempting to reorganize under Chapter 11 are ongoing concerns that generate income used to pay pre-petition creditors. *Whiting Pools, supra,* 462 U.S. at 203, 103 S.Ct. at 2312. Furthermore, a liquidating corporation's debts are not discharged in bankruptcy. 11 U.S.C. § 727(a)(1) (1988). The fresh start policy, therefore, does not apply to corporate debtors. *City of New York v. Quanta Resources Corp. (In re Quanta Resources Corp.),* 739 F.2d 912, 915 n.7 (3 Cir.1984), *aff'd,* 474 U.S. 494, 106 S.Ct. 755, 88 L.Ed.2d 859 (1986); *In re Blanton,* 105 B.R. 811, 824 (Bankr.W.D.Tex.1989); *see also* Note, *Bankruptcy and the Union's Bargain: Equitable Treatment of Collective Bargaining Agreements,* 39 Stan.L.Rev. 1015, 1025 n.67 (1987) ("the fresh start policy does not apply to corporations"). Thus, the concern that the *Segal* Court expressed does not apply to a situation involving a corporate debtor. When the fresh start policy is not implicated, the argument for including NOL carryforwards as property of the bankruptcy estate is strengthened. *Compare In re Beery, supra,* 116 B.R. at 810 (NOL carryforward is property of the estate; fresh start policy not implicated since individual not entitled to discharge because of misconduct) *with Davis, supra,* 69 T.C. at 827–28 (relying on detriment to fresh start policy in case where NOL carryforward had value only to debtor, but not to estate, to conclude that it was not property of the estate).

Finally, in determining the scope of § 541 we must consider the purposes animating the Bankruptcy Code. *Kokoszka v. Belford,* 417 U.S. 642, 645, 94 S.Ct. 2431, 2433, 41 L.Ed.2d 374 (1974); *Lines v. Frederick,* 400 U.S. 18, 19, 91 S.Ct. 113, 113, 27 L.Ed.2d 124 (1970); *Segal, supra,* 382 U.S. at 379, 86 S.Ct. at 515. Including NOL carryforwards as property of a corporate debtor's estate is consistent with Congress' intention to "bring anything of value that the debtors have into the estate." H.R.Rep. No. 95–595, 95th Cong., 2d Sess. 176, *reprinted in* 1978 U.S.Code Cong. & Admin.News 5963, 6136. Moreover, "[a] paramount and important goal of Chapter 11 is the rehabilitation of the debtor by offering breathing space and an opportunity to rehabilitate its business and eventually generate revenue." *International Ass'n of Machinists and Aerospace Workers v. Eastern Air Lines, Inc.,* 121 B.R. 428, 433 (S.D.N.Y.1990), *aff'd,* 923 F.2d 26 (2 Cir.1991). Including the right to a NOL carryforward as property of PLI's bankruptcy estate furthers the purpose of facilitating the reorganization of PLI. The fact that both plans for reorganization contemplated its availability to the reorganized company suggests that PLI's $74 million NOL was a valuable asset of PLI.

We hold that the right to a carryforward attributable to its $74 million NOL was property of PLI's bankruptcy estate.

IV.

[7] We turn now to PSS' contention that the bankruptcy court erred in enjoining it from taking a worthless stock deduction on its 1988 tax return. We hold that the injunction entered by the bankruptcy court was proper.

The commencement of a bankruptcy case operates to stay "any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate." 11 U.S.C. § 362(a)(3) (1988). "The reach of the automatic stay is limited by its purposes." *Price & Pierce Int'l, Inc. v. Spicers Int'l Paper Sales, Inc.,* 50 B.R. 25, 26 (S.D.N.Y.1985); *accord Rett White Motor Sales Co. v. Wells Fargo Bank,* 99 B.R. 12, 13 (N.D.Cal.1989). One of the principal purposes of the automatic stay is to preserve the property of the debtor's estate for the benefit of all the creditors. *Holtkamp v. Littlefield* ***574** *(In re Holtkamp),* 669 F.2d 505, 508 (7 Cir.1982); *In re Fed. Press Co.,* 117 B.R. 942, 946 (Bankr.N.D.Ind.1989); *In re Gatke Corp.,* 117 B.R. 406, 408 (Bankr.N.D.Ind.1989).

In the instant case, if PSS were allowed to take a worthless stock deduction on its 1988 tax return, it would effectively eliminate the value of the NOL carryforward to PLI and thus have an adverse impact on PLI's reorganization. The use of NOLs as tax deductions following a change in ownership of a corporation is governed by 26 U.S.C. § 382 (1988). The amount of the deduction is limited to "the value of the old loss corporation" multiplied by "the long-term tax-exempt rate". 26 U.S.C. § 382(b) (1988). A change of ownership is deemed to have occurred if a greater than 50 percent shareholder takes a worthless stock deduction, but retains the stock at the end of the taxable year. 26 U.S.C. § 382(g)(4)(D) (1988). The value of the old loss corporation is generally measured by the value of the stock immediately prior to the ownership change. 26 U.S.C. § 382(e)(1) (1988). Since PSS owned 100 percent of the stock of PLI, if it declared that stock to be worthless and retained ownership of the stock at the end of the taxable year, the value of the PLI stock would be zero for the purposes of § 382. Accordingly, the "new" corporation would not be entitled to any NOL carryforward.

In *48th St. Steakhouse, Inc. v. Rockefeller Group, Inc. (In re 48th St. Steakhouse, Inc.),* 835 F.2d 427 (2 Cir.1987), *cert. denied,* 485 U.S. 1035, 108 S.Ct. 1596, 99 L.Ed.2d 910 (1988), we held that a landlord's attempt to terminate its lease with a non-debtor was subject to the automatic stay since it would have had the legal effect of terminating the debtor's sublease. *Id.* at 431. Despite the fact that the landlord's action was not directed specifically at the debtor, we held that

> "where a non-debtor's interest is intertwined ... with that of a bankrupt debtor ... [and an] action taken against the non-bankrupt party would inevitably have an adverse impact on property of the bankrupt estate, then such action should be barred by the automatic stay."

Id. Similarly, where a non-debtor's action with respect to an interest that is intertwined with that of a bankrupt debtor would have the legal effect of diminishing or eliminating property of the bankrupt estate, such action is barred by the automatic stay.

In the instant case, PSS' interest in its worthless stock deduction is intertwined with PLI's NOL. If PSS were permitted to take a worthless stock deduction on its 1988 tax return, it would have an adverse impact on PLI's ability to carryforward its NOL. Accordingly, despite the fact that PSS' action is not directed specifically at PLI, it is barred by the automatic stay as an attempt to exercise control over property of the estate.

[8] The permanent injunction entered by the bankruptcy court also is supported by its equitable powers pursuant to § 105(a). That provision grants the bankruptcy court power to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Bankruptcy Code]." 11 U.S.C. § 105(a) (1988). "This provision has been construed liberally to enjoin [actions] that might impede the reorganization process." *MacArthur Co. v. Johns–Manville Corp. (In re Johns–Manville Corp.),* 837 F.2d 89, 93 (2 Cir.), *cert. denied,* 488 U.S. 868 (1988). In light of the testimony of the parties that the $74 million NOL was a valuable asset of PLI, we will not disturb the bankruptcy court's finding that elimination of the right to apply its NOL to offset income on future tax returns would impede PLI's reorganization.

Finally, we consider PSS' claim that the bankruptcy court was without jurisdiction to enter the injunction. PSS relies for this proposition on a series of cases that held that § 505(a)(1) of the Bankruptcy Code, which gives the bankruptcy court the power to "determine the amount or legality of any tax", does not confer jurisdiction on the bankruptcy court to adjudicate the tax liability of non-debtors. *E.g., American Principals Leasing Corp. v. United States,* 904 F.2d 477, 480–81 (9 Cir.1990); ***575** *Brandt–Airflex Corp. v. Long Island Trust Co., N.A. (In re Brandt–Airflex Corp.),* 843 F.2d 90, 95–96 (2 Cir.1988); *In re Vermont Fiberglass, Inc.,* 88 B.R. 41, 43–44 (D.Vt.1988).

In the instant case, the bankruptcy court did not determine the amount or legality of PSS' tax liability. The bankruptcy court's power was based on its jurisdiction over property of the estate. *In re Johns–Manville Corp., supra,* 837 F.2d at 91. Having properly exercised jurisdiction, the bankruptcy court may enter an injunction that affects derivative rights of a non-debtor. *Id.* at 92–93.

V.

Since we hold that the bankruptcy court's injunction was justified based on count three of the complaint, we find it neither necessary nor appropriate to consider the issues raised by the cross-appeal of the Creditors' Committee and Cold Spring.

VI.

To summarize:

We hold that the right to carryforward a tax deduction due to the NOL attributable to PLI's pre-bankruptcy operation was property of PLI's bankruptcy estate. We further hold that PSS' attempt to take a worthless stock deduction with respect to its PLI stock that would effectively destroy the value of the NOL carryforward generated by PLI was properly enjoined by the bankruptcy court. We do not consider the issues raised by the cross-appeal.

Affirmed.

Parallel Citations

67 A.F.T.R.2d 91-972, 59 USLW 2590, 92-2 USTC P 50,491, 24 Collier Bankr.Cas.2d 1503, 21 Bankr.Ct.Dec. 838, Bankr. L. Rep. P 73,863

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501 B.R. 549
United States Bankruptcy Court, S.D. New York.

In re: Residential Capital, LLC, et al., Debtors.
Official Committee of Unsecured Creditors, on behalf of the estates of the Debtors, Plaintiff,
v.
UMB Bank, N.A., as successor indenture trustee under that certain Indenture, dated as of June 6, 2008; and Wells Fargo Bank, N.A., third priority collateral agent and collateral control agent under that certain Amended and Restated Third Priority Pledge and Security Agreement and Irrevocable Proxy, dated as of December 30, 2009, Defendants.
Residential Capital, LLC, et al, Plaintiffs,
v.
UMB BANK, N.A., as successor indenture trustee under that certain Indenture, dated as of June 6, 2008; and Wells Fargo Bank, N.A., third priority collateral agent and collateral control agent under that certain Amended and Restated Third Priority Pledge and Security Agreement and Irrevocable Proxy, dated as of December 30, 2009, Defendants.

Case No. 12–12020 (MG) Jointly Administered | Adversary Proceeding No. 13–01277(MG), Adversary Proceeding No. 13–01343 (MG) | Filed 11/15/2013

Synopsis

Background: Consolidated proceedings were brought for determination as to whether junior secured noteholders' collateral had value exceeding amount of their claims, such that noteholders were entitled to postpetition interest and fees, as well as for determination of noteholders' alleged right to unmatured original issue discount (OID) as addition to their secured claims and to payment on priority basis under debtors' proposed Chapter 11 plan based on alleged failure of adequate protection provided in cash collateral order. Debtors and creditors' committee also asserted claim for avoidance of transfers made to junior noteholders on preference theory.

Holdings: The Bankruptcy Court, Martin Glenn, J., held that:

[1] debtors' issuance of new notes to debenture holders as part of prepetition consensual workout, in connection with fair value debt-for-debt exchange, did not give rise to claim disallowable as one for unmatured interest;

[2] junior noteholders failed to satisfy their burden of showing that aggregate value of their collateral had diminished from date that debtors filed for Chapter 11 relief, and were not entitled to adequate protection claim payable on priority basis under plan;

[3] mortgage loans included in property of jointly administered Chapter 11 estates were properly valued, for purpose of determining the undersecured, secured, or oversecured nature of claims collateralized by these loans, using fair market valuation;

[4] paragraph in cash collateral order could not be interpreted as reviving junior secured noteholders' liens in collateral that had been released;

[5] refinancing opportunities associated with mortgage servicing rights that were expressly identified as "excluded" assets could not be separated from servicing rights themselves;

[6] no value could be assigned to goodwill of debtors' residential mortgage loan origination/servicing business as of date their Chapter 11 petitions were filed;

[7] junior secured noteholders did not have perfected liens that were protected from strong-arm avoidance in any deposit accounts

[8] plaintiffs asserting preference claims failed to satisfy burden of showing that challenged transfers enabled junior secured noteholders to receive more than they would have received in hypothetical Chapter 7 liquidation; and

[9] "carve out" provision in cash collateral order had to be interpreted as requiring junior secured noteholders to subordinate their secured claims to payment of carve out only if there were insufficient other unencumbered assets from which carve out could be paid.

So ordered.

West Headnotes (33)

[1] **Bankruptcy** Claims or proceedings against estate or debtor; relief from stay

Bankruptcy Bankruptcy judges

Bankruptcy court, even as non-Article-III court, had constitutional authority to enter final orders and judgment in proceeding brought for determination of junior secured noteholders' right to postpetition interest and fees as allegedly oversecured creditors, for determination of whether their claims based on original issue discount (OID) should be disallowed as claims for unmatured interest, and for whether they had adequate protection claims, as raising issues that would necessarily be resolved as part of claims-allowance process.

Cases that cite this headnote

[2] **Bankruptcy** Evidence

Consolidated Financial Data Repository (CFDR) that Chapter 11 debtors maintained in ordinary course of their business as primary means for complying with their collateral tracking and reporting requirements under revolving loan agreement, as a Sarbanes–Oxley (SOX) compliant financial tool that was auditable, verifiable, and subject to heightened level of scrutiny, constituted a reliable and accurate business record which contained contemporaneous record of debtors' business transactions, and evidence of which was admissible under "business records" exception to hearsay rule as proof of what collateral had been released and what collateral was subject to junior secured noteholders' security interest in proceeding for determination of junior secured noteholders' allegedly oversecured status and purported entitlement to postpetition interest and fees. 11 U.S.C.A. § 506(b).

Cases that cite this headnote

[3] **Bankruptcy** Post-petition interest

While Chapter 11 debtors' issuance of new notes to debenture holders as part of prepetition consensual workout, in connection with fair value debt-for-debt exchange, might result in an original issue discount (OID) for tax purposes, it did not give rise to claim for OID that was disallowable under the Bankruptcy Code as claim for unmatured interest; treating this transaction as giving rise to claim for OID that would be disallowable in bankruptcy would discourage

parties from entering into consensual workouts to alleviate financial distress and would result in increased resort to bankruptcy process. 11 U.S.C.A. § 502(b)(2).

Cases that cite this headnote

[4] **Bankruptcy** Presumptions and burden of proof

In establishing its claim, secured creditor generally bears burden of proving amount and extent of its lien. 11 U.S.C.A. § 506(a).

Cases that cite this headnote

[5] **Bankruptcy** Adequate protection in general

Bankruptcy Order of court and proceedings therefor in general

Bankruptcy Lease

Once amount and extent of creditor's secured claim has been established, burden shifts to debtor seeking to use, sell, lease, or otherwise encumber creditor's collateral to prove that secured creditor's interest will be adequately protected. 11 U.S.C.A. §§ 363, 364, 506(a).

Cases that cite this headnote

[6] **Bankruptcy** Determination of priority

Junior secured noteholders complaining of sufficiency of adequate protection granted to them in cash collateral order, and asserting priority claim based on this alleged insufficiency, bore burden of proof on issue. 11 U.S.C.A. § 507(b).

Cases that cite this headnote

[7] **Bankruptcy** Determination of priority

To establish their entitlement to claim payable on priority basis under debtors' proposed Chapter 11 plan, based on alleged insufficiency of adequate protection granted to them in cash collateral order, junior secured noteholders had to show that aggregate value of their collateral diminished from the petition date to effective date of plan. 11 U.S.C.A. § 507(b).

Cases that cite this headnote

[8] **Bankruptcy** Superpriority; extension of credit or failure of adequate protection

Bankruptcy Valuation

In assessing value of junior secured noteholders' collateral on petition date, for purposes of deciding whether aggregate value of collateral had diminished from petition date to effective date of debtors' proposed Chapter 11 plan such that noteholders were entitled to priority claim based on insufficiency of adequate protection granted to them in cash collateral order, bankruptcy court would utilize fair market valuation, rather than valuing collateral based on its liquidation value, where junior secured noteholders had entered into cash collateral stipulation to allow sale of debtors' assets as going concern, and where going concern valuation was consistent with debtors' stated purpose in filing for Chapter 11 relief, which included "preserv[ation of] the debtors' [mortgage loan] servicing business on a going concern basis for sale." 11 U.S.C.A. § 507(b).

1 Cases that cite this headnote

[9] **Bankruptcy** Superpriority; extension of credit or failure of adequate protection

Junior secured noteholders failed to satisfy their burden of showing that aggregate value of their collateral had diminished from date that debtors filed for Chapter 11 relief to effective date of debtors' proposed plan, and were not entitled to claim payable on priority basis under plan based on alleged insufficiency of adequate protection granted to them in cash collateral order; while debtors had admittedly spent money that belonged to noteholders, they did so in manner that benefited noteholders, the value of whose collateral on petition date was very substantially impaired by reason of existing defaults that prevented debtors from disposing of collateral at that time, but which debtors, through settlements and consents achieved over many months at great effort and expense, were ultimately able to sell on very favorable terms. 11 U.S.C.A. § 507(b).

Cases that cite this headnote

[10] **Bankruptcy** Oversecurity

Determination as to whether junior secured noteholders were oversecured, as required for them to be entitled to postpetition interest and fees in debtors' jointly administered Chapter 11 cases, did not have to be made on debtor-by-debtor basis, but could be made by aggregating their claims against debtor entities, given that no debtor would be required to pay junior secured noteholders more than the value of their collateral; allowing aggregation of claims and collateral more accurately reflected realities of case and of business world at large, given that junior secured noteholders' indenture, like most indentures, allowed debtors to move assets among their subsidiaries, and to create new subsidiaries, as long as noteholders continued to maintain their liens in these assets. 11 U.S.C.A. § 506(b).

Cases that cite this headnote

[11] **Bankruptcy** Transfer and Consolidation of Cases

Absent substantive consolidation, bankruptcy court will not pool assets of multiple debtors to satisfy their liabilities.

Cases that cite this headnote

[12] **Bankruptcy** Transfer and Consolidation of Cases

Substantive consolidation is to be used sparingly, in recognition of dangers of forcing creditors of one debtor to share on parity with creditors of less solvent debtor.

Cases that cite this headnote

[13] **Bankruptcy** Adequacy of price; appraisal

When Chapter 11 debtor's assets are sold in arm's-length transaction, fair market value of assets is conclusively determined by the price paid.

Cases that cite this headnote

[14] **Bankruptcy** Amount secured; partial security

Bankruptcy Oversecurity

Mortgage loans included in property of jointly administered Chapter 11 estates of debtors that were leading originators and servicers of residential mortgage loans were properly valued, for purpose of determining the undersecured, secured, or oversecured nature of claims collateralized by these loans, using fair market valuation, rather than a recovery analysis that discounted the figures on debtors' balance sheet based on assumed costs of collection, where

debtors, in prior cash collateral order, had expressly waived right to surcharge collateral for costs of collection. 11 U.S.C.A. § 506(a-c).

Cases that cite this headnote

[15] **Bankruptcy** Weight and sufficiency

While value of junior secured noteholders' security interests in equity that Chapter 11 debtors enjoyed in their non-debtor subsidiaries might perhaps be reduced based on contingent liabilities that subsidiaries faced in pending litigation, debtors, as parties seeking this reduction for purposes of establishing that junior noteholders were undersecured and not entitled to postpetition interest, had to present evidence of risk-adjusted equity value to account for litigation risk, and could not simply rely upon litigation risk to value equity interests at $0.00. 11 U.S.C.A. § 506(b).

Cases that cite this headnote

[16] **Bankruptcy** Proceedings

Paragraph in cash collateral order could not be interpreted as reviving junior secured noteholders' liens in collateral that had been released to allow Chapter 11 debtors to use it to obtain postpetition financing from another lender, where no party had ever disclosed this purported effect of paragraph in question when cash collateral order was proposed or at any contemporaneous hearing, and where junior noteholders' interpretation of paragraph, as reviving their liens and according them priority even above lien interest of lender from which debtors obtained this postpetition financing, would not have been agreed to by lender, which relied on priority of its lien in making postpetition advances under cash collateral order.

Cases that cite this headnote

[17] **Bankruptcy** Oversecurity

Refinancing opportunities associated with mortgage servicing rights that were expressly identified as "excluded" assets not subject to junior secured noteholders' liens, while not themselves excluded from general intangibles to which junior noteholders' liens attached, could not be separated from servicing rights themselves, and did not provide any additional security to junior secured noteholders, which bankruptcy court had to consider in assessing whether noteholders were oversecured and entitled to postpetition interest and fees. 11 U.S.C.A. § 506(b).

Cases that cite this headnote

[18] **Bankruptcy** Oversecurity

No value could be assigned to goodwill of debtors' residential mortgage loan origination/servicing business as of date their Chapter 11 petitions were filed, and bankruptcy court did not have to consider this value in assessing whether noteholders were oversecured and entitled to postpetition interest and fees, where value subsequently allocated to goodwill in connection with postpetition sale of debtors' assets was result of settlements and consents that debtors ultimately achieved over many months, at great effort and expense, in order to make assets ready for sale; any goodwill reflected in postpetition sale of debtors' assets was not shown to exist on petition date, when value of debtors' assets was seriously impaired and subject to steep reductions in value to account for litigation risks, potential seizure of certain mortgage servicing rights, and termination of rights and setoff by trustees of residential mortgage-backed securities. 11 U.S.C.A. § 506(b).

Cases that cite this headnote

[19] **Bankruptcy** Particular cases and problems

Bankruptcy Oversecurity

Any goodwill generated postpetition for Chapter 11 debtors' residential mortgage loan origination/servicing business was not product solely of debtors' use of cash collateral of junior secured noteholders but of settlements that debtors negotiated with government entities and trustees of residential mortgage-backed securities, such that junior secured noteholders' liens did not attach to this postpetition goodwill as product or offspring of their cash collateral, and bankruptcy court did not have to consider postpetition goodwill in assessing whether junior noteholders were oversecured and entitled to postpetition interest and fees. 11 U.S.C.A. §§ 506(b), 552(b).

Cases that cite this headnote

[20] **Bankruptcy** Oversecurity

Bankruptcy Evidence

Bankruptcy court could rely on extrinsic evidence, including testimony of employees of debtors and of other parties to ambiguous prepetition security agreement, to find that excluded assets became part of junior secured noteholders' collateral, pursuant to all–asset granting clause in security agreement, once assets ceased to be excluded assets; accordingly, bankruptcy court had to consider such previously excluded assets in assessing whether junior noteholders were oversecured and entitled to postpetition interest and fees. 11 U.S.C.A. § 506(b).

Cases that cite this headnote

[21] **Secured Transactions** After-acquired property

Under New York law, security interest arising by virtue of after-acquired property clause is no less valid than security interest in collateral in which debtor has rights at the time value is given. N.Y. Uniform Commercial Code § 9-204.

Cases that cite this headnote

[22] **Bankruptcy** Particular cases and problems

Bankruptcy Debtor in possession

Secured Transactions Duration of filing; continuation statement

Secured Transactions Filing release

Under New York law, financing statements previously filed by junior secured noteholders continued in effect even after new financing statements were filed following release of portion of collateral securing junior noteholders' claims, and placed third parties on notice of need to investigate noteholders' interest in the released collateral after it was reacquired by Chapter 11 debtors, so as to prevent avoidance of security interest that noteholders possessed in this reacquired collateral pursuant to strong-arm statute. 11 U.S.C.A. § 544; N.Y. Uniform Commercial Code § 9-502.

Cases that cite this headnote

[23] **Bankruptcy** Particular cases and problems

Bankruptcy Debtor in possession

Bankruptcy Oversecurity

Junior secured noteholders did not have perfected liens that were protected from strong-arm avoidance in any deposit accounts of Chapter 11 debtors for which an executed control agreement could not be produced, and bankruptcy court

did not have to consider any such accounts in assessing whether junior noteholders were oversecured and entitled to postpetition interest and fees. 11 U.S.C.A. §§ 506(b), 544; N.Y. Uniform Commercial Code § 9-312(b)(1).

Cases that cite this headnote

[24] **Secured Transactions** Possession by secured party without filing

Under New York law, security interest in deposit account may be perfected only by control of account. N.Y. Uniform Commercial Code § 9-312(b)(1).

Cases that cite this headnote

[25] **Mortgages** Effect in general

Under New York law, in order to perfect lien on real property, secured party must duly record against the title of such property a properly executed mortgage or deed of trust.

Cases that cite this headnote

[26] **Bankruptcy** Mortgages and pledges

Bankruptcy Debtor in possession

Bankruptcy Oversecurity

In absence of properly executed and duly recorded mortgage or deed of trust, any lien rights that junior secured noteholders possessed in real property of Chapter 11 debtors was avoidable by debtors in exercise of strong-arm powers as debtors-in-possession, and did not have to be considered by bankruptcy court in assessing whether junior noteholders were oversecured and entitled to postpetition interest and fees. 11 U.S.C.A. §§ 506(b), 544.

Cases that cite this headnote

[27] **Bankruptcy** Elements and Exceptions

Bankruptcy Preferences

In preference-avoidance proceeding, trustee bears burden of proving each of statutory elements of preference claim, and unless trustee proves each and every one of these elements, transfer is not avoidable as preference. 11 U.S.C.A. § 547(b)(1-5).

Cases that cite this headnote

[28] **Bankruptcy** Preferences

When creditor asserts that it was oversecured at time of its receipt of alleged preferential transfer, such that transfer did not enable it to receive more than it would have received in hypothetical Chapter 7 liquidation, it is plaintiff's burden to refute that assertion. 11 U.S.C.A. § 547(b)(5).

Cases that cite this headnote

[29] **Bankruptcy** Preferences

Absent evidence regarding value of junior secured noteholders' collateral either at start of preference period or when they received allegedly preferential transfers, such as might permit bankruptcy court to determine that they were not oversecured, parties asserting preference claims failed to satisfy burden of showing that challenged transfers enabled

junior secured noteholders to receive more than they would have received in hypothetical Chapter 7 liquidation. 11 U.S.C.A. § 547(b)(5).

Cases that cite this headnote

[30] **Bankruptcy** Proceedings

"Carve out" is provision in cash collateral order that allows for some expenditure of administrative and/or professional fees to be paid before secured creditor gets paid on its collateral.

Cases that cite this headnote

[31] **Bankruptcy** Proceedings

Unless it conflicts with provisions of the Bankruptcy Code, "carve out" provision in cash collateral order is construed by applying normal contract interpretation principles.

Cases that cite this headnote

[32] **Bankruptcy** Proceedings

Usual purpose of "carve out" in cash collateral order is to ensure the payment of specified administrative expenses from secured creditor's collateral in event that bankruptcy case goes badly, use of cash collateral is terminated, and sufficient unencumbered funds are no longer available to administer case.

Cases that cite this headnote

[33] **Bankruptcy** Proceedings

Absent anything in cash collateral order to suggest contrary intent, "carve out" provision in order had to be interpreted in manner consistent with general purpose of "carve out" provisions, as requiring junior secured noteholders to subordinate their secured claims to payment of carve out only if there were insufficient other unencumbered assets from which carve out could be paid.

Cases that cite this headnote

Attorneys and Law Firms

***555** Morrison & Foerster LLP, Attorneys for Debtors, 1290 Avenue of the Americas, New York, NY 10104, By: Gary S. Lee, Esq., Jamie A. Levitt, Esq., Stefan W. Engelhardt, Esq.

Kramer Levin Naftalis & Frankel LLP, 1177 Avenue of the Americas, New York, NY 10036, Counsel for the Official Creditors' Committee, By: Kenneth H. Eckstein, Esq., Gregory A. Horowitz, Esq.

Pachulski Stang Ziehl & Jones, Conflicts Counsel to Official Creditors' Committee, 780 Third Avenue, 36th Floor, New York, NY 10017, By: Robert J. Feinstein, Esq., John A. Morris, Esq.

White & Case LLP, Attorneys for Ad Hoc Group of Junior Secured Noteholders, 1155 Avenue of the Americas, New York, NY 10036, By: J. Christopher Shore, Esq., Douglas P. Baumstein, Esq., Dwight A. Healy, Esq.,

Akin Gump Strauss Hauer & Feld LLP, Special Counsel to UMB Bank, N.A., One Bryant Park, New York, NY 10036, By: David M. Zensky, Esq., Deborah Newman, Esq., Brian T. Carney, Esq.

Reed Smith LLP, Attorneys for Wells Fargo as Collateral Agent, 599 Lexington Avenue, 22nd Floor, New York, NY 10022, By: David M. Schlecker, Esq.

Chapter 11

MEMORANDUM OPINION, AND FINDINGS OF FACT AND CONCLUSIONS OF LAW, AFTER PHASE I TRIAL

MARTIN GLENN, UNITED STATES BANKRUPTCY JUDGE

ResCap and the Creditors' Committee (the "Plaintiffs") are co-proponents of a reorganization plan that treats the junior secured noteholders ("JSNs") as undersecured, but would pay them the face amount of all principal and prepetition interest ($2.222 billion, less $1.1 billion repaid ***556** postpetition). The JSNs voted against and oppose confirmation of the plan.

The JSNs contend they are oversecured and entitled to postpetition interest (at the default rate) and fees; they also contend they are entitled to recover an adequate protection claim of $515 million based on alleged diminution in value of their prepetition collateral used during the case under a series of consensual cash collateral orders.[1] They also contend that their collateral should be increased as the result of an "all assets" pledge, which purportedly attaches to the Debtors' assets that (1) were once excluded from the "all assets" pledge but no longer are, (2) were released from the JSNs' liens but were subsequently reacquired by the Debtors, or (3) were never properly released from the JSNs' liens at all.

1 The value of the JSNs' purported adequate protection claim will increase or decrease based on the value of the JSNs' Collateral on the Petition Date and on the Effective Date. This Opinion will resolve some issues relating to both values.

The Plaintiffs contend that (1) the JSNs are undersecured and, therefore, not entitled to postpetition interest and fees; (2) the JSNs' collateral has not declined in value since the petition date and thus the JSNs cannot assert an adequate protection claim; (3) the JSNs' collateral should be reduced from lien challenges to deposit accounts and real estate owned ("REO") assets; (4) the Debtors' transfers of approximately $270 million of collateral to the undersecured JSNs in the 90 days before bankruptcy are avoidable preferences; and (5) and the principal amount of the JSNs' claim must be reduced by approximately $386 million for unmatured interest arising from original issue discount ("OID") created as part of the Debtors' "fair value" debt-exchange offer in 2008.

The swing between the JSNs' projected recoveries under the proposed plan and their "ask" is at least $350 million, or perhaps more. In other words, the parties are fighting about a lot of money.

The legal issues are framed in two adversary proceedings, one filed by the Debtors and the other by the Creditors' Committee (the "Committee") after it was given standing in an order granting an STN motion. The two adversary proceedings, asserting both claims and counterclaims, were consolidated. In two earlier written decisions, the Court granted in part (sometimes with prejudice and sometimes without prejudice) and denied in part motions to dismiss some of the claims and counterclaims. (*See In re Residential Capital, LLC,* 495 B.R. 250 (Bankr.S.D.N.Y.2013), ECF Doc. # 74, and *In re Residential Capital, LLC,* 497 B.R. 403 (Bankr.S.D.N.Y.2013), ECF Doc. # 100.[2]) Familiarity with those decisions is assumed.

2 All docket numbers listed refer to the Adversary Proceeding Docket 13–01277, unless otherwise noted.

The Court established an expedited schedule for discovery and trial. The trial was bifurcated into two phases because some issues involve only the Plaintiffs and Defendants (as defined below) while other issues potentially involve other creditor constituencies in the case. The Phase I trial, conducted between October 15–23 and on November 6, 2013, was limited to disputed issues between the Plaintiffs and Defendants, to simplify the trial and limit the number of parties that felt it necessary to actively participate; the Phase II trial, involving issues potentially affecting the Plaintiffs, Defendants and a broader group ***557** of parties in interest in the bankruptcy case, will be part of the contested plan confirmation hearing now scheduled to begin on November 19, 2013.

On August 23, 2013, the parties submitted an agreed list of issues for trial. (ECF Doc. # 84.) A Joint Pretrial Conference Order, approved by the Court on October 18, 2013, provides stipulations of fact, the parties' factual and legal contentions, and exhibit and witness lists. (ECF Doc. # 161.) All direct fact and expert sworn witness testimony was filed in advance, with the witnesses in court during the trial for cross and re-direct examination. Motions *in limine* to preclude some of the proposed expert testimony were granted in part and denied in part. (Oct. 16 Tr. 8:2–15.[3]) Deposition designations and counter-designations were introduced into evidence at trial mostly without objections.[4] Voluminous exhibits were admitted in evidence at trial, mostly without objections. The parties' filed post-trial submissions on November 1, 2013, and conducted closing arguments on November 6, 2013.

3 [Date] Tr. [Citation] refers to transcripts of the Phase I trial. References to [Name] Direct [Citation] refer to direct testimony submitted in writing before the trial began and available on the public docket. Plaintiffs' exhibits are referenced by number (e.g., PX 1), and Defendants' exhibits are referenced by letter (e.g., DX A). All references to page numbers in the Plaintiffs' exhibits refer to the PX page numbers at the bottom of each page (e.g., PX 1 at 51 refers to PX 1 at page 51 of 120.) All references to page numbers in the Defendants' exhibits refer to the DX page numbers at the bottom of the each page. References to [Name] Dep. [Citation] refer to the deposition testimony designated for the Phase I trial. Citations to "PTO ¶ __" are to the stipulated facts contained in the Revised Joint Pretrial Order entered in the consolidated adversary proceedings. (ECF Doc. # 161.)

4 Any remaining objections to deposition designations are overruled.

This Opinion resolves the legal and factual issues in the Phase I trial. The Court completed the Opinion quickly because the outcome of the Phase I trial impacts Phase II and the confirmation hearing. This Opinion contains the Court's findings of fact and conclusions of law pursuant to FED. R. CIV. P. 52, made applicable to these adversary proceedings by FED. R. BANKR. P. 7052. In making its findings of fact, the Court has resolved credibility issues and the weight appropriately given to conflicting evidence. Where contested or disputed facts or opinions were offered during trial, this Opinion reflects the Court's resolution of those disputes, whether or not the opinion specifically refers to the contrary evidence introduced by the opposing parties.

[1] All of the issues in the Phase I trial are "core," as provided in 28 U.S.C. § 157(b)(2). Because the JSNs (through UMB, the indenture trustee) submitted a proof of claim in this case, seeking to recover all principal, prepetition and postpetition interest and fees, and have asserted an adequate protection claim, all of the issues raised and resolved in these adversary proceedings necessarily must be resolved as part of the claims-allowance process. Therefore, the Court concludes that it has the constitutional authority to enter final orders and judgment in these adversary proceedings. Because issues in these adversary proceedings remain to be resolved following the Phase II trial and confirmation hearing, no final judgment can be entered now. This Opinion does include the Court's final resolution of the issues upon which it now rules.

The results of the Phase I trial can be viewed as a split decision—some issues have been resolved in favor of the Plaintiffs and some in favor of the Defendants. Subject to the outcome of the Phase II ***558** trial, the Court concludes that the JSNs' claim should not be reduced for unmatured OID; the JSNs have failed to establish that they are entitled to recover an adequate protection claim; the JSNs have liens on certain contested collateral, including certain intangible assets, but the JSNs do not have liens on the full extent of the collateral claimed; the Plaintiffs have failed to establish that the JSNs received avoidable preferences during the preference period (as defined below); and the JSNs are undersecured and not entitled to postpetition interest and fees. As explained below, the Court concludes that (subject to the results of the Phase II trial) the JSNs are undersecured by approximately $318 million.

I. *BACKGROUND*

On May 14, 2012 (the "Petition Date"), the Debtors filed voluntary petitions for relief under chapter 11 of the Bankruptcy Code. Since the Petition Date, the Debtors have continued to operate their businesses and manage their properties as debtors in possession. Before filing for bankruptcy, the Debtors were a leading originator of residential mortgage loans and, together with their non-Debtor affiliates, the fifth largest servicer of residential mortgage loans in the United States, servicing approximately $374 billion of domestic residential mortgage loans and working with more than 2.4 million mortgage loans across the United States. (Marano Direct ¶ 23.)

Defendant UMB Bank, N.A. ("UMB") is the successor indenture trustee (in such capacity, the "Notes Trustee") for the 9.625% Junior Secured Guaranteed Notes due 2015 issued by ResCap (the "Junior Secured Notes" or the "Notes"). (PTO ¶ 3.) Wells Fargo Bank, N.A. ("Wells Fargo")—also a defendant—is the third priority collateral agent and collateral control agent for the Junior Secured Notes. (*Id.* ¶ 4.) Defendant Ad Hoc Group of holders of Junior Secured Notes (the "Ad Hoc Group" or the "JSNs" and, together with the Notes Trustee, the "Defendants"[5]) comprises entities that hold, or manage entities that hold, Junior Secured Notes. Membership in the Ad Hoc Group changes from time to time, as set forth in the Ad Hoc Group's statements periodically filed with the Court pursuant to Rule 2019 of the Federal Rules of Bankruptcy Procedure. (*Id.* ¶ 6.)

5 Although Wells Fargo is also a defendant, this opinion refers to UMB and the Ad Hoc Group as the "Defendants" to simplify referring to those parties.

The Defendants' claims against the Debtors' estates arise from Junior Secured Notes that ResCap issued pursuant to an Indenture dated June 6, 2008. (PX 1.) Those notes and the collateral securing those notes are discussed in greater detail below. As of the Petition Date, the JSNs held secured claims against ResCap, and certain of its affiliates as guarantors and grantors, in the face amount of $2.222 billion, consisting of $2.120 billion in unpaid principal as of the Petition Date, and $101 million in unpaid prepetition interest. (DX ABF at 3.) The issue whether the face amount of the claim should be reduced by unamortized OID is discussed in section III.A below.

A. The Adversary Proceedings

1. Complaints and Counterclaims

In or about July 2012, the Committee began investigating what it believed to be security interests improperly asserted by the Defendants. The Committee filed its complaint on February 28, 2013 (ECF Doc. # 1), seeking among other things (1) a declaratory judgment on claims that (a) certain of the Debtors' property is not ***559** subject to liens or security interests in favor of the JSNs, and that (b) certain liens or security interests on property of the Debtors are unperfected; (2) an order avoiding the JSNs' allegedly unperfected liens on or security interests in certain property; (3) an order avoiding as preferential certain liens or security interests allegedly granted for the Defendants' benefit within 90 days of the Petition Date; (4) an order characterizing postpetition payments to the Defendants' professionals as payments of principal;[6] (5) an order clarifying the priority of the JSNs' liens; and (6) an order disallowing the JSNs' claims pending final resolution of the Committee's complaint; and (7) an order disallowing a portion of the JSNs' claims as a result of unmatured interest allegedly arising from the 2008 debt-for-debt exchange. (*Id.*)

6 Paragraph 16(c)(v) of the Final CashCollateral Order provides that the JSNs are entitled to, as part of adequate protection, prompt payment of reasonable fees and expenses, whether accrued prepetition or postpetition, for certain identified professionals. (PX 76 at 30.) The provision also provides that "nothing shall prejudice the rights of any party to seek to recharacterize any such payments ... as payments of principal under the Junior Secured Notes." (*Id.*) The issue was not addressed by the parties during the Phase I trial.

On May 3, 2013, the Debtors filed a Complaint (ECF 13–01343, Doc. # No. 1), and filed an Amended Complaint on June 19, 2013. (ECF 13–01343 Doc. # 8.) In their amended complaint, the Debtors seek declaratory judgments, including among other things that: (1) the JSNs' lien on general intangibles does not include any lien on the proceeds of, or value attributed to, the sale of assets pursuant to the Ocwen Asset Purchase Agreement dated November 2, 2012 ("Ocwen APA"); (2) the JSNs are not entitled to an adequate protection replacement lien; (3) the JSNs are not entitled to a lien on the assets that secure the Amended and Restated Loan Agreement, dated December 30, 2009 ("AFI LOC"), or any other collateral under the Notes Indenture (defined below) that was released by Wells Fargo; (4) the JSNs are not entitled to a lien on any recoveries of any future avoidance actions brought by or on behalf of the Debtors' estates; (5) the JSNs are undersecured and not entitled to postpetition interest; (6) if the JSNs are found to be entitled to postpetition interest, the interest should be awarded at the contractual nondefault rate of interest; and (7) the JSNs are undersecured because they are not oversecured at any individual Debtor entity.

On June 21, 2013, the Court entered an order consolidating the Committee's action with the Debtors' action. (ECF Doc. # 41.) On June 28, the Defendants filed an Answer, Affirmative Defenses and Counterclaims to the Debtors' Amended Complaint. (ECF 13–01343 Doc. # 14.) On July 29, 2013, the Defendants amended their answer and counterclaims. (ECF 13–01343 Doc. # 29.) Those amended counterclaims seek declaratory relief: (1) establishing the ownership and value of the stipulated and disputed collateral and the assets pledged in support of the JSNs; (2) establishing that the JSNs have a lien on claims against Ally Financial, Inc. ("AFI"); (3) determining the distributable value to be generated from all intercompany claims and causes of action; (4) allocating the purchase prices of Debtor assets sold in Court-approved sales; (5) establishing that the JSNs have a lien on the purportedly released assets; (6) determining that the use of cash collateral results in diminution in the collateral's value; (7) enforcing the Debtors' section 506(c) waiver; (8) defining the exact quantum of the direct costs of liquidating collateral; (9) determining the amount of the JSNs' adequate ***560** protection liens; (10) reallocating administrative expenses; (11) establishing that the JSNs are entitled to postpetition interest, default interest, fees, and expenses; (12) determining that the claims asserted by any residential mortgage backed security trust ("RMBS Trust"), monoline insurers, and RMBS certificate-holders must be subordinated; and (13) establishing that the claims against AFI identified by the Examiner[7] appointed in the chapter 11 proceedings and/or the property that is the subject of those claims, constitute the JSNs' collateral.

7 On June 20, 2012, the Court directed that an examiner be appointed (ECF 12–12020 Doc. # 454). On July 30, 2012, the Court approved Arthur J. Gonzalez as the examiner ("Examiner") (ECF 12–12020, Doc. # 674), and on June 26, 2013, the *Report of Arthur J. Gonzalez, as Examiner* was made publicly available (ECF Doc. # 3698).

2. Motions to Dismiss

On April 30, 2013, UMB filed a motion to dismiss with prejudice Counts I, IV, V, VII, XI, XII, XIII and XIV of the Committee's complaint in their entirety, and Counts III and X in part. (ECF Doc. # 20.) UMB later withdrew its motion to dismiss certain of those counts, and on July 26, 2013, the Court heard oral argument on UMB's motion. (ECF. Doc. # 61.) The Court entered an opinion and order granting in part and denying in part UMB's motion. (ECF Doc. # 74.) In that opinion, the Court dismissed Count V and denied without prejudice UMB's motion to dismiss Counts I, IV, and XIII. (*Id.*) *See Residential Capital,* 495 B.R. at 250.

On July 16, 2013, the Defendants filed a Motion to Dismiss Counts 3 and 5 of the Debtors' Amended Complaint. (ECF Doc. # 52.) That same day, the Plaintiffs filed a motion to dismiss fourteen of the Defendants' counterclaims. (ECF Doc. # 53.) The Court heard oral argument on both of those motions to dismiss on August 28, 2013, and subsequently issued a memorandum opinion and order (1) denying the Defendants' motion without prejudice, and (2) granting in part and denying in part the Plaintiffs' motion. (ECF. Doc. # 100.) *See Residential Capital,* 497 B.R. at 403.

B. The Trial

On August 23, 2013, the parties entered into a Joint Statement of Issues, which the Court so-ordered. (ECF Doc. # 84.) That statement of issues contemplated a bifurcated adjudication whereby certain issues would be decided in a Phase I trial, and

others would be decided in a Phase II trial (if necessary). The Phase I trial issues include (1) "[w]hether and to what extent any unamortized portion of the alleged original issue discount on the Junior Secured Note[holders]' claim should be disallowed as unmatured interest," (2) "valuation of each Debtor's collateral ... securing the JSN claims, on a debtor-by-debtor basis, and the appropriate methodologies for conducting such valuation," [8] (3) "[w]hether and to what extent the JSNs have liens on various items of disputed collateral ... including issues related to avoidance of preferential transfers, disputed lien releases, asserted equitable liens resulting therefrom, and potential avoidance of any such equitable liens," (4) adequate protection issues, including "[w]hether and to what extent the JSNs' collateral has diminished in value as a result of the Debtors' use of cash collateral; whether the JSNs are entitled to an adequate protection claim for some or all of that value diminution; and, if the Court deems it appropriate to decide during ***561** Phase I, whether as a matter of law the JSNs might be entitled to adequate protection for any diminution in value associated with the Debtors' entry into the Global Settlement," (5) "the appropriate allocation of proceeds to JSN collateral from the Debtors' asset sales to Ocwen and Walter" (described below), (6) "[w]hether the JSNs have a lien on all or any portion of the AFI Contribution, [9] and/or all or any of causes of action of the Debtors or avoidance claims that the Debtors may bring that are being settled in the Global Settlement," [10] and (7) "[w]hether under section 506 of the Bankruptcy Code, the [Noteholders] may recover postpetition interest and other fees, costs, or charges under the Indenture (a) only to the extent they are oversecured by assets at a single Debtor entity without reference to collateral at other Debtor entities; (b) to the extent they are oversecured with reference to all collateral held by any Debtor, collectively; and/or (c) to the extent that the Debtors collectively have sufficient assets to pay the [Noteholders'] claims in full and/or any particular Debtor is solvent." (*Id.*) [11]

8 The parties did not present evidence at trial of the value of the JSNs' collateral on a debtor-by-debtor basis, but instead focused on the aggregate value of the JSNs' collateral.

9 The "AFI Contribution" is a $2.1 billion cash contribution AFI agreed to make to the Debtors' estates pursuant to the terms of the settlement among the Debtors, the Committee, AFI, and the Consenting Claimants set forth in Article IV of the Debtors' Joint Chapter 11 Plan.

10 During the trial, the Court determined that issues relating to liens on the AFI Contribution would be tried in Phase II.

11 The issues reserved for Phase II include (1) the value of intercompany balances, (2) the treatment of various claimant classes, (3) allocation of the AFI Contribution, (4) the value of collateral, oversecurity, and interest and fees if not determined in Phase I, and (5) a final calculation of the Defendants' adequate protection claim, if applicable. (*Id.*)

The Court conducted a six-day hearing on Phase I from October 15–17 and October 21– 23, 2013. The parties submitted the written direct testimony of 13 witnesses: Teresa Rae Farley ("Ms. Farley"), John D. Finnerty ("Dr. Finnerty"), James Gadsden ("Gadsden"), Marc E. Landy ("Mr. Landy"), Thomas Marano ("Mr. Marano"), Marc D. Puntus ("Mr. Puntus"), and Mark Renzi ("Mr. Renzi"), for the Plaintiffs; and Michael Fazio ("Mr. Fazio"), Jeffrey M. Levine ("Mr. Levine"), Ronald J. Mann ("Mr. Mann"), P. Eric Siegert ("Mr. Siegert"), John A. Taylor ("Mr. Taylor"), and Scott Winn ("Mr. Winn"), for the Defendants. Each of these witnesses was subjected to cross-examination and redirect at trial. Neither party called any rebuttal witnesses. The Plaintiffs and the Defendants sent their final exhibit lists to the Court post trial. More than 700 exhibits were admitted in evidence, some for limited purposes. The Parties filed amended consolidated deposition designations on October 29, 2013 (ECF Doc. # 179).

II. *FINDINGS OF FACT*

A. The Notes, the Collateral, and the Loan Facilities

1. The AFI Revolver and the Junior Secured Notes

On or about June 4, 2008, Residential Funding Company, LLC ("RFC") and GMAC Mortgage LLC ("GMAC"), as borrowers, ResCap and certain other entities as guarantors, and certain entities as obligors, entered into a revolving loan facility (the "Revolver") as amended from time to time. The Revolver was provided under a Loan Agreement (the "Original Revolver Loan Agreement"), dated June 4, 2008 (and amended from time to time before December 30, 2009), with AFI as initial lender and lender agent. (PTO ¶ 10; PX ***562** 5.) To secure the obligations under the Revolver, ResCap and certain of its subsidiaries, as grantors, granted a security interest in favor of Wells Fargo, as First Priority Collateral Agent and Collateral Control Agent, pursuant to a First Priority Pledge and Security Agreement and Irrevocable Proxy (the "Original Revolver Security Agreement"), dated June 4, 2008 (and amended from time to time before December 30, 2009). (PTO ¶ 11; PX 7.) ResCap also issued $4.01 billion in face principal amount of Junior Secured Notes (the "Junior Secured Notes") pursuant to an indenture dated as of June 6, 2008 (the "Notes Indenture"). (PX 1 § 1.01.) Interest accrues on the Junior Secured Notes at an annual 9.625% rate.[12] (*Id.* at 8.) ResCap issued those Junior Secured Notes with certain other entities serving as guarantors and obligors,[13] and with U.S. Bank National Association, as the original indenture trustee. (*Id.*) To secure the obligations under the notes, ResCap and the guarantors under the Notes Indenture granted a security interest in favor of Wells Fargo—the Third Priority Collateral Agent—pursuant to the Third Priority Pledge and Security Agreement and Irrevocable Proxy (the "Original JSN Security Agreement"), dated June 6, 2008 (and amended from time to time before December 30, 2009). (PTO ¶ 13; PX 3.)

12 The Notes Indenture also provided that "[t]he [Borrower] will pay interest (including postpetition interest in any proceeding under any Bankruptcy Law) on overdue principal at the rate equal to 1% per annum in excess of the then applicable interest rate on the Notes to the extent lawful; it will pay interest (including postpetition interest in any proceeding under any Bankruptcy Law) on overdue installments of interest and Additional Interest (without regard to any applicable grace period) at the same rate to the extent lawful." (PX 1 § 4.01.)

13 The guarantor entities that are Debtors in these chapter 11 proceedings (the "Guarantor Debtors") guaranteed ResCap's obligations under the Notes Indenture, including the obligation to pay in full all principal, interest, fees, and premiums, if any, with respect to the Junior Secured Notes. (PX 1 § 10.01.)

Pursuant to Original Revolver Security Agreement and the Original JSN Security Agreement, the collateral securing the Revolver was identical to the collateral securing the Junior Secured Notes. (*See* PX 7, PX 3.)[14] On December 30, 2009, the Original Revolver Security Agreement, the Original Revolver Loan Agreement, and Original JSN Security Agreement were amended and restated, giving rise to the "Revolver Loan Agreement," the "Revolver Security Agreement," and the "JSN Security Agreement." Following those amendments, the collateral securing the agreements remained identical. (*See* PX 8, PX 4.) The Plaintiffs contend that certain collateral was later pledged to the Revolver but not to the JSNs, which the Court will address below.

14 ResCap also issued senior secured notes that were secured by the same collateral, but those notes were satisfied in full before the petition date and are not central to the present dispute.

Since the collateral securing the Revolver and the Junior Secured Notes was identical, the creditors entered into an Intercreditor Agreement on June 6, 2008. (PX 2.) That agreement governs the Revolver Collateral Agent's ability to enforce rights associated with collateral. The governing documents expressly authorize the Collateral Agent, at the request of the Debtors, to release liens on the collateral previously securing the Revolver and the JSNs. Any lien releases executed by the Revolver Collateral Agent were binding on the Junior Secured Notes.

2. Primary Collateral and Blanket Lien Collateral

The Revolver and Junior Secured Notes were secured by two categories of collateral: ***563** Primary Collateral and Blanket Lien Collateral. (PTO ¶ 12.) Primary Collateral was specifically delineated on the schedules to the AFI Revolver and served as the borrowing base under the AFI Revolver. Primary Collateral was subject to various operational and reporting requirements. (Farley Direct ¶ 24; Farley Dep. 48:14–21.)

Blanket Lien Collateral encompassed the balance of the collateral pledged as security under the AFI Revolver and not falling within the definition of "Excluded Assets."[15] (Farley Direct ¶ 25.) The Blanket Lien Collateral included assets that were not Primary Collateral, "whether [such assets were] now or hereafter existing, owned or acquired and wherever located and howsoever created, arising or evidenced." (PX 3 at 11–12; *see also* PX 4 at 15.) All of the assets that came in to ResCap (except Excluded Assets) after the parties executed the Original JSN Security Agreement were subject to the JSNs' third priority lien due to the blanket lien. (*See* PX 3 at 11–13; PX 4 at 15–17.)

15 *See infra* II.H.5 for discussion of Excluded Assets.

Between the Primary and Blanket Lien Collateral, the JSNs' collateral included (1) assets and property of ResCap, the Notes Guarantors, and the Additional Notes Grantors (other than Excluded Assets);[16] (2) certain equity interests, certain promissory notes and other debt instruments, certain deposit and security accounts, and certain related assets of the Notes Equity Pledgors; (3) all "Financial Assets" (as defined in Article 8 of the U.C.C.) and certain related assets of the FABS Grantors (as defined in the JSN Security Agreement); and (4) certain deposit accounts and certain related assets of the Additional Account Parties (collectively, the "JSN Collateral"). (PX 4.)

16 Pursuant to the JSN Security Agreement, the assets included "accounts, chattel paper, commercial tort claims, deposit accounts, financial assets, investment property, intellectual property, and general intangibles" of ResCap and the Notes Guarantors and Additional Grantors. (PX 4.) Although the JSN Security Agreement listed "Commercial Tort Claim described on Schedule V" as collateral, no commercial tort claims were identified or listed on Schedule V. Schedule V was never amended or modified. As a result, the Court previously found that the Defendants do not have a properly perfected lien on any Commercial Tort Claims. (*See* ECF Doc. # 100.)

Primary Collateral could only be released if proceeds of that collateral were used to pay down the AFI Revolver or to buy replacement collateral. (*See* PX 1 at 56.) Blanket Lien Collateral, on the other hand, could be released without the same restrictive requirements. (Farley Direct ¶ 25; Oct. 16 Tr. 180:4–8.)

The Notes Indenture and the JSN Security Agreement combined to permit the Debtors to incur future indebtedness secured by liens, to conduct certain asset sales, and to release JSN Collateral so long that release was part of a transaction not prohibited by the Notes Indenture. (PX 1 §§ 1.01, 4.01, 8.04(a)(i); PX 4 § 7.) Additionally, the Intercreditor Agreement allowed the First Priority Collateral Agent to release liens on any collateral in connection with a sale or disposition of the collateral allowed under the Revolver Agreements and the Junior Secured Notes Agreement. (PX 2 § 3.1.) That collateral release would be binding on the JSNs. (*Id.*) The Debtors could only release JSN Collateral pursuant to the JSN Security Agreement, the Notes Indenture, and the Intercreditor Agreement. Additionally, the JSN Indenture allowed the Debtors to move assets among their subsidiaries, and to create new subsidiaries, as long as the JSNs continued to maintain liens on such ***564** assets. (PX 1 § 4.7 (requiring all "Significant Subsidiaries" to become "Guarantors" and thus also "Grantors" under the JSN Pledge Agreement).)

3. The AFI LOC and Released Blanket Collateral

In 2009, the Debtors determined that they needed additional financing to continue operating their businesses. To that end, on or about December 30, 2009, RFC and GMAC, as borrowers, entered into the AFI LOC, provided under an Amended and Restated Loan Agreement ("LOC Loan Agreement" with AFI as initial lender and lender agent). (PTO ¶ 18; PX 9.) To secure the obligations under the AFI LOC, ResCap and certain other Debtors granted a security interest to AFI pursuant to the Amended and Restated Pledge and Security Agreement and Irrevocable Proxy, dated December 30, 2009 (as amended from time to time, the "LOC Security Agreement") with GMAC Investment Management LLC, as secured party, and AFI, as omnibus agent, lender agent, lender and secured party. (PTO ¶ 19.) Granting that security interest to secure the AFI LOC required the First Priority Collateral Agent and Third Priority Collateral Agent to release their respective liens on certain collateral. (PX 134; Farley Direct ¶¶ 52–61.)

In 2010 and 2011, the Third Priority Collateral Agent released its lien on a variety of assets included in the JSN Collateral so the collateral could be pledged to secure the AFI LOC, including (1) certain mortgage loans, servicing rights and other assets (the "Released Loan Collateral"), and (2) certain Freddie Mac servicing advances (the "Released Advances," and collectively with the Released Loan Collateral, the "Released Blanket Collateral"). (PX 134.) To effectuate the releases, the Third Priority Collateral Agent executed (1) a Partial Release of Collateral, dated May 14, 2010, releasing the security interest in the Released Loan Collateral that previously secured the Junior Secured Notes, and (2) a Partial Release of Collateral, dated May 27, 2011, that released the security interest in the Released Advances that previously secured the Junior Secured Notes (together with the May 14, 2010 release, the "Blanket Releases"). (PX 130 at 1176–1305, PX 134.) The Third Priority Collateral Agent also filed U.C.C.–3 amendments that removed the Released Blanket Collateral from the collateral set forth in the original U.C.C.–1s (as amended) filed by the Third Priority Collateral Agent. (PX 131; PX 133.) Exhibits annexed to these U.C.C.–3s contained descriptions of the Released Blanket Collateral that were identical to those in the Blanket Releases themselves. (*Id.*)

The May 14, 2010 release described various categories of Released Loan Collateral, including any existing or future rights in "Subject Mortgage Loan [s]." The release defined those loans as:

> Any Mortgage Loan (a) which is identified in a Mortgage Schedule delivered under the LOC Loan Agreement, (b) the carrying value of which is included in the calculation of the borrowing base included in a borrowing base report or a monthly collateral report under the LOC Loan Agreement, or (c) which is indicated in a Relevant Party's [17] books and records as having been pledged to the Lender Agent. [18]

(PX 134 at 8.) Thus, a mortgage loan listed as AFI LOC collateral on the Debtors' books and records would qualify as a Subject ***565** Mortgage Loan that was released. The LOC Loan Agreement defines mortgage loans to mean residential mortgage loans and any right to receive payment from the Federal Housing Administration and Department of Veterans Affairs ("FHA/VA") for insurance or guarantees of residential mortgage loans. [19] (PX 9 at 87; PX 10 at 100.)

17 A "Relevant Party" is an obligor under the Revolver Security Agreement or the JSN Security Agreement.

18 AFI was the Lender Agent.

19 FHA/VA loans are repurchased whole loans from Ginnie Mae trusts. (DX ABI at 58.) Since these assets are partially insured, the amounts paid by the Debtors to repurchase these loans are substantially reimbursable. (*Id.*) The Debtors also have the choice of modifying or selling these Ginnie Mae repurchased loans to a Ginnie Mae trust or third party. (*Id.*) The Debtors always intended to sell the FHA/VA loans but ultimately pulled the FHA loans from the auction because they felt the bids received were not high enough. (Puntus Direct ¶ 117.)

Other categories of collateral released under the Blanket Loan Release included (1) "Servicing Rights Collateral," defined as all of RFC's and GMAC's rights under existing or future agreements pursuant to which they were obligated to perform collection, enforcement or similar services to maintain and remit funds collected from mortgagees; and (2) all intangible assets and other general intangibles relating to Subject Mortgage Loans and Servicing Rights Collateral. (PX 134 at 6–8.)

The May 27, 2011 release described various categories of Released Advances that were being released from the JSNs' liens. These assets included any existing and future advances relating to mortgage loans and real estate owned property made pursuant to certain contracts with Freddie Mac. (*See* PX 130 at 1181–83.)

B. The Debtors' Books and Records

[2] To comply with the numerous collateral tracking and reporting requirements of the Revolver Loan Agreement, the Debtors developed and implemented technological systems and operational procedures. (Farley Direct ¶ 29.) Starting in 2008, the Consolidated Financial Data Repository, or "CFDR," became the Debtors' primary record for tracking their assets and was maintained in the ordinary course of the Debtors' business. (Farley Direct ¶¶ 29–30; *see also* PX 139.) The CFDR tracks various

categories of assets, including without limitation, held for sale ("HFS") and held for investment ("HFI") mortgage loans, FHA/VA receivables, servicing advances, lending receivables, service fees and late charges, REO property, trading securities, and mortgage servicing rights. (Farley Direct ¶ 30 n.4.) Each asset is marked in the CFDR to reflect the facility to which it has been pledged. (Oct. 16 Tr. 194:3–10.) Because the collateral pools for the Revolver and the Junior Secured Notes were the same, the CFDR tracked the JSN Collateral by tracking the Revolver collateral. (Farley Direct ¶ 30.)

Assets comprising Primary Collateral under the Revolver Security Agreement are tracked and marked in the CFDR as pledged to the Revolver. (Oct. 16 Tr. 194:3–6.) Assets comprising Blanket Lien Collateral under the Revolver are also tracked, but before the Petition Date, those assets were marked as "Unpledged" in the CFDR because (1) the Debtors were not required, and the CFDR was not used, to report on Blanket Lien Collateral; and (2) Blanket Lien Collateral was not subject to the same constraints relating to use of proceeds as Primary Collateral. (Farley Direct ¶ 35.) Not all unpledged assets constituted Blanket Lien Collateral, though, because Excluded Assets under the Revolver Security Agreement and JSN Security Agreement would also be listed as unpledged. (Farley Direct ¶ 35; Oct. 16 Tr. 194:7–10.)

***566** Shortly before the Petition Date, the Debtors updated the CFDR to comply with stricter reporting and cash tracking requirements attendant to the bankruptcy process and recoded assets constituting Blanket Lien Collateral from "Unpledged" to "Blanket Lien Collateral." (Ruhlin Dep. 119:4–9, 155:16–156:2, 156:15–21; Farley Direct ¶ 36; Farley Dep. 115:4–14.) When the Debtors repurposed the CFDR in 2012 and began specifically tracking blanket lien collateral, "what [ResCap] viewed as blanket lien collateral was no longer included as unpledged. It was marked otherwise to be more specific that it related to pledged collateral in some way." (Ruhlin Dep. 119:4–9; *see also* Farley Dep. 138:4–11 ("Shortly before the filing date ... since [ResCap was] going to have to start reporting on all assets which had been subject to the blanket lien at the time of the filing date, there was an effort undertaken to label all of the assets which were in [ResCap's] view ... subject to the blanket lien.").)

During the trial, Ms. Farley testified that the CFDR is a Sarbanes–Oxley ("SOX") compliant financial tool that is auditable, verifiable, and subject to a heightened level of scrutiny and attention by the Debtors'/AFI's SOX teams and the Debtors' external auditors, Deloitte & Touche. (Farley Direct ¶ 43; Oct. 16 Tr. 233:1–6, 234:23–235:25.) Ms. Farley also testified that these controls were rigorous because the CFDR was a critical financial technology for the Debtors. (Oct. 16 Tr. 235:24–25.) Ms. Farley further detailed the strict controls on the collateral tracking process under the CFDR, including the processes for (1) designating an asset as being pledged to a particular facility; (2) changing an asset's designation; (3) reconciling any inconsistencies between the CFDR data, the general ledger, and source data submitted by various business units; and (4) submitting collateral reports under the Revolver and LOC Facility. (Farley Direct ¶¶ 30 n.4, 33–34, 38–42; Oct. 16 Tr. 194:1–10; *see also* PX 162.)

Following Ms. Farley's testimony, over the Defendants' objection, the Court admitted the CFDR in evidence as a business record maintained by the Debtors in the ordinary course of business. (Oct. 17 Tr. 32:17–33:17, 40:7–41:18.) The Court expressly finds that the CFDR is a reliable and accurate business record containing a contemporaneous record of the Debtors' business transactions concerning the assets tracked in the system. The Court also expressly finds that the Defendants' challenge to the CFDR is unpersuasive.

1. The CFDR and the Released Blanket Collateral

The CFDR constituted the Debtors' books and records by which the they tracked collateral pledged to various facilities. Thus, collateral listed as pledged to the AFI LOC in the CFDR would meet the definition of a Subject Mortgage Loan released by the Third Party Collateral Agent (discussed above) as part of the Blanket Releases.

The JSNs claim that they have a lien on $910 million of collateral that was identified in the CFDR as pledged to the AFI LOC on the Petition Date. That collateral is composed of categories of assets that were released under either of the Blanket Releases.[20] (Farley Direct ¶ 62.) The ***567** JSNs argue that other evidence of the release of this $910 million of JSN Collateral should exist, including schedules of mortgage loans, notices of collateral additions to the LOC Loan Agreement, and electronic templates

used to update the CFDR. The Debtors, though, either did not maintain all these documents or did not locate them in their searches during discovery. (*See* ECF 13–01343 Doc. # 117; *see also* Oct. 16 Tr. 237:6–239:14.)

20 The $910 million questioned by the Ad Hoc Group is composed of four categories of assets (domestic mortgage loans, FHA/VA receivables, REO properties, and servicing advances) and three of these categories (comprising approximately 97% of the assets at issue) are covered by the Blanket Loan Release. Mortgage loans ($550.4 million) and FHA/VA receivables ($324.7 million) fall within the express definition of "Subject Mortgage Loans." REO properties ($5.9 million) are merely proceeds obtained upon foreclosure of mortgage loans and are therefore covered as well. (*See* DX AHD at 24 (setting forth the values of the various asset classes purportedly lacking evidence of release).) The last category of assets questioned by the Ad Hoc Group—servicing advances ($29.4 million)—is covered by the Servicing Advance Release. The Servicing Advance Release covers Freddie Mac servicing advances (PX 130 at 1181–83), which were the only types of servicing advances pledged as collateral to the AFI LOC on the Petition Date. Farley Direct ¶ 62 & n.7. Therefore, the Servicing Advance Release covered all servicing advances that were pledged as collateral to secure the LOC Facility.

Regardless, there is no dispute that $910 million of collateral is listed in the CFDR as pledged to the AFI LOC; nor is there any dispute that the $910 million comprises categories of assets that were released under the Blanket Releases. In ruling on the motions to dismiss, the Court held that the description of the collateral covered by the releases satisfied the requirements of the Uniform Commercial Code ("U.C.C.") section 9–108(b). *Residential Capital,* 497 B.R. at 418. Therefore, the Court finds that the $910 million was effectively released, and no further evidence is necessary to support those releases. The absence of the additional records sought by the Defendants is not sufficient to overcome the evidence that was introduced at trial. The Court expressly finds that a preponderance of the evidence supports the finding that the $910 million of collateral was released from the JSNs' lien and pledged to the AFI LOC.

C. Events Leading Up to the Debtors' Bankruptcy

In August 2011, the Debtors began to contemplate out-of-court restructuring opportunities, a potential chapter 11 filing, financing alternatives and asset sales. To that end, in October 2011, ResCap retained Centerview Partners LLC ("Centerview") to assist in this process. (Puntus Direct ¶¶ 1, 16, 40, 41, 43; Marano Direct ¶ 28.) In December 2011 and January 2012, faced with significant debt maturities coming due in spring 2012, the Debtors and Centerview began evaluating, and launched a process to obtain, a stalking horse bid(s) for a chapter 11 sale of all or a substantial portion of the Debtors' assets. (Puntus Direct ¶¶ 3, 16, 44; Marano Direct ¶ 29.) Contemplating a potential bankruptcy filing, the Debtors wanted to obtain debtor-in-possession ("DIP") financing, secure a stalking horse bid, and continue to work with government-sponsored entities ("GSEs") and regulators to maintain the Debtors' GSE mortgage servicing rights ("MSRs"). (Marano Direct ¶ 3 1.) The Debtors also wanted to resolve potential claims against AFI to obtain AFI's support for the business and resolve litigation threats asserted by RMBS trustees. (*Id.*)

1. Stalking Horse Bids

On or about January 23, 2012, Centerview launched a marketing process for the Debtors' assets. (Puntus Direct ¶ 48.) After developing a list of potential bidders, Centerview contacted five potential bidders and negotiated nondisclosure agreements with each one. (*Id.*) Centerview made clear that the Debtors would consider bids for any and all asset combinations, including bids on individual assets. (*Id.*) ***568** Centerview also opened a data room to facilitate bidder due diligence, and the Debtors held multi-day management presentations with three of the five potential bidders. (*Id.*)

In February 2012, Centerview received three preliminary indications of interest from (a) Nationstar Mortgage LLC ("Nationstar") (PX 27), (b) Ocwen Loan Servicing LLC ("Ocwen") (PX 25), and (c) a certain undisclosed financial bidder (PX 17). The financial bidder's letter of intent ("LOI") included a bid of $1.5 billion for the Debtors' mortgage loan origination and servicing assets (the "Servicing and Origination Assets") and portions of the Debtors' whole loan portfolio (the "Whole Loan Portfolio"). Nationstar also submitted an LOI, which included a bid of $2.6 billion for a substantial portion of the Debtors' assets.

(Puntus Direct ¶ 49.) Ocwen's initial LOI was a bid of $1.426 billion to acquire solely the Debtors' private label securitization ("PLS") MSRs and associated advances. (*Id.*) The Debtors and their advisors determined that proceeding with two of the three bidders—Nationstar and the financial bidder—was most prudent. (*Id.* ¶ 50.) Centerview then approached each of the two with a detailed request for supplemental information. (*Id.*) To that end, on February 22, 2012, Centerview sent a letter to Fortress Investment Group LLC ("Fortress")—Nationstar's primary shareholder—requesting additional clarification related to Nationstar's bid. (PX 366.) Centerview asked Nationstar to clarify how it would allocate its bid among the purchased assets, "including but not limited to a separate allocation for each of the financial assets (MSR, advances, whole loan portfolio) as well as the servicing and origination platforms, respectively."[21] (*Id.*) In its response to Centerview's questions about bid allocation, Fortress specified that it would allocate no value to either the consumer lending or servicing platforms. (PX 28 at 2.)

21 The servicing platform related to the MSRs includes, *inter alia,* software servicing contracts, employee contracts and certain other operating expenses relating to the MSRs (Oct. 15 Tr. 171: 8–17), and the origination platform related to the MSRs includes the call center. (Oct. 15 Tr. 172: 1–6.)

Nationstar submitted a revised LOI on February 28, 2012, increasing the purchase price on assets included in its initial bid by $100 million, and expanding the assets purchased to include GSE and PLS advances. (Puntus Direct ¶ 5 1.) It also increased its total bid for the Debtors' mortgage loan origination and servicing assets and Whole Loan Portfolio to $4.2 billion for the Debtors' mortgage loan origination and servicing assets and Whole Loan Portfolio. (*Id.*) Nationstar's bid on the Whole Loan Portfolio was contingent on AFI providing better-than-market debt financing for such portfolio. (*Id.*) After this bid, the Debtors decided to proceed with Nationstar as the exclusive bidder on the assets. (*Id.* ¶ 52.) In early March 2012, the Debtors and their advisers negotiated the terms of the asset purchase agreement with Nationstar (the "Nationstar APA"), and Nationstar completed its analysis of the Debtors' business. (*Id.* ¶ 55.)

During April and May of 2012, AFI decided not to provide Nationstar debt financing related to the Debtors' Whole Loan Portfolio, and offered its own bid of $1.4 to $1.6 billion to acquire those assets, depending on whether the sale was effectuated through a section 363 sale or chapter 11 plan. (*Id.* ¶ 56.) AFI's decision not to provide financing caused the value of Nationstar's overall bid to decrease. (*See* PX 52 at 6.) The Debtors' professionals determined that AFI's bid to acquire the Whole Loan Portfolio was superior to Nationstar's ***569** bid for those assets, particularly because AFI was not seeking any stalking horse protections in connection with the sale and had submitted a draft asset purchase agreement with very favorable terms for the Debtors. (Puntus Direct ¶ 56.) Thus, the Debtors and their advisors negotiated the terms of an asset purchase agreement with AFI (the "AFI APA").

The Debtors' Board of Directors approved both APAs. (*Id.* ¶ 57.) On May 13, 2012, both APAs were executed and delivered by the parties. (*Id.*) On the Petition Date, the Debtors filed two stalking horse bids with the Bankruptcy Court: Nationstar's $2.3 billion stalking horse bid for the Debtors' mortgage loan origination and servicing assets (encompassed in the Nationstar APA), and AFI's $1.4 to 1.6 billion bid for the Debtors' Whole Loan Portfolio (encompassed in the AFI APA). (Puntus Direct ¶ 57; Marano Direct ¶ 58.)

2. Communications and Settlements with Various Parties

During the prepetition auction process, the Debtors regularly communicated with the GSEs concerning the proposed agreement and plans for maintaining the Debtors' origination and servicing operations as a going concern until closing of the final sale to preserve the value of the MSRs and associated advances. (Marano Direct ¶ 50; Puntus Direct ¶ 45.) Through these regular contacts, the Debtors convinced the GSEs that the Debtors could sell the assets without damaging the MSRs and associated advances. (Puntus Direct ¶ 46.) The stakes were high: if the GSEs had concluded that ResCap could not operate or credibly pursue an orderly sale of the mortgage servicing assets, and that the GSE-related assets might therefore have been subject to liquidation, the GSEs would raise the cost of doing business and seize their assets. (Marano Direct ¶ 51.) By obtaining financing,

use of cash, continuity of management through the end of sale, and a stalking horse bidder, the Debtors reassured the GSEs that during the chapter 11 sale process, the Debtors' business would continue to function as usual pending the sale. (*Id.*)

Before the Petition Date, the Debtors negotiated a settlement with the Department of Justice, the Department of Housing and Urban Development, and the attorneys general of 49 states (the "DOJ/AG Settlement") to resolve potential claims arising out of origination and servicing activities and foreclosure matters. (*Id.* ¶ 7.) The DOJ/AG Settlement required that the Debtors pay approximately $110 million in cash and provide various specified forms of borrower relief with a value of at least $200 million and that the Debtors—and any purchaser of the Debtors' assets—implement a remedial program of loan modification and enhanced servicing measures, both subject to ongoing regulatory monitoring and oversight, and imposed increased operational costs. (*Id.* ¶ 53.) Also before the bankruptcy filing, the Debtors entered into a consent order settling an investigation by the Federal Reserve Board (the "FRB Consent Order") arising out of the same general facts as the DOJ/AG Settlement. (*Id.* ¶ 54.) The terms of the FRB Consent Order required ResCap to pay a penalty of $207 million, as well as to enhance various aspects of their origination and servicing business, including their compliance and internal audit programs, internal audit, communications with borrowers, vendor management, employee training, and oversight by the Board of Directors. (*Id.*) The Consent Order required the Debtors—and any purchaser of the Debtors' assets—to maintain ***570** compliance with the terms of the order.[22] (*Id.*)

22 A significant modification of the FRB Consent Order—effectively reducing the Debtors' costs of compliance—was negotiated during this case and approved by the Court.

3. Prepetition Settlements and Plan Support Agreements

Before the Petition Date, the Debtors entered into plan support agreements with AFI and certain other parties in interest—including certain of the current Ad Hoc Group members—whereby the parties committed to support, subject to certain terms and conditions, the Debtors' effort to pursue a chapter 11 plan pursuant to the terms provided in the Plan Term Sheet, dated May 14, 2012 (the "Prepetition Plan Term Sheet"). (PX 432.) The Prepetition Plan Term Sheet contemplated, among other things, that AFI would make a cash contribution in exchange for estate and third party releases. (PTO ¶ 24.) The Debtors and AFI reached a prepetition settlement approved by the ResCap board on May 13, 2012 (the "Original AFI Settlement"). (Marano Direct ¶ 40.) That settlement was memorialized in a Plan Sponsor Agreement. (*Id.*) Under the terms of the Original AFI Settlement, AFI agreed to pay the Debtors $750 million, continue to support the Debtors' origination business in chapter 11, provide a stalking horse bid for the Whole Loan Portfolio, provide DIP financing, and continue to provide the Debtors the shared services it needed to run its business. (*Id.* ¶ 41.) The Original AFI Settlement and Plan Sponsor Agreement also provided for the automatic termination of the agreements if the Court did not approve a chapter 11 plan on or before October 31, 2012. AFI and the Debtors agreed to monthly waivers of this automatic termination through February 28, 2013. (*Id.* ¶ 41; Puntus Direct ¶ 35.)

Under the plan support agreement entered into with the JSNs (the "JSN PSA"), the JSNs would have waived all rights to postpetition interest through December 31, 2012, so long as no unsecured creditor received postpetition interest, the JSN PSA did not terminate, and the effective date of the plan occurred by December 31, 2012, or (1) the closing of contemplated asset sales occurred by December 31, 2012, and (2) the effective date of the plan occurred by March 31, 2013. (Puntus Direct ¶ 33.) The JSN PSA also would have provided that AFI would subordinate a portion of its liens and claims to the JSNs. (*Id.*)

At the same time that the Debtors were negotiating with AFI, they were also negotiating with the trustees of certain RMBS trusts (the "RMBS Trusts") for which the Debtors acted as sponsor, depositor, or in a similar capacity. (*Id.* ¶ 37.) These negotiations related to resolution of approximately $44 billion of potential liability for representation and warranty and servicing claims arising out of the Debtors' private-label residential mortgage backed securities. (Marano Direct ¶ 43.) The Debtors believed that resolving these private-label securities claims was crucial to enhancing the value of the Debtors' assets for a potential sale. (*Id.*) The overhang of this litigation exposure had impeded the Debtors' sale efforts in the years before the chapter 11 filing and would have diminished the value the Debtors' creditors could have obtained in a chapter 11 sale. (*Id.*) Further, the RMBS

Trustees (the "RMBS Trustees") threatened to assert the right to withhold servicing advances owed to the Debtors as an offset against origination and servicing liabilities allegedly owed to them. (*Id.*)

In May 2012, the Debtors reached a proposed settlement with the institutional ***571** investors holding a substantial stake in the RMBS Trusts (the "RMBS Settlement"). (*Id.* ¶ 44.) ResCap's board of directors approved that agreement on May 13, 2012. (*Id.*)

With the stalking horse bids, proposed settlements, and plan support agreements in place, the Debtors filed their chapter 11 cases on May 14, 2012. Any notion that the Court was being presented with a pre-packaged bankruptcy was short-lived, however, and these cases rapidly descended into warfare threatening the Debtors' ability to continue operating as a going concern.

4. Termination of the Initial Plan Support Agreements

By late September 2012, two events occurred that altered the calculus of the JSNs who supported the prepetition PSA. (Siegert Direct ¶ 12.) First, with the auction still a month away, there was no longer any possibility of an expedited distribution upon a rapid sale closing. (*Id.*) Second, the Committee challenged certain of the JSNs' liens within the challenge period prescribed by the Cash Collateral Order. (*Id.*) The Ad Hoc Group then terminated the prepetition term sheet and inserted an express reservation of rights regarding adequate protection and allocation of expenses in each extension of the Cash Collateral Order. (*Id.*)

D. The Cash Collateral Order

To keep their business operating as debtors-in-possession, the Debtors sought to obtain postpetition financing and authorization to use the cash collateral encumbered by existing debt facilities. (Marano Direct ¶ 33; Puntus Direct ¶ 17.) The continued funding would allow the Debtors to (1) continue to issue loans and offer loan modifications to thousands of borrowers; (2) continue to service mortgages and make advances associated with such servicing obligations; (3) comply with the Federal Reserve and FDIC consent order; (4) comply with the DOJ/AG Settlement; (5) comply with the agreements that had been entered into with the GSEs mandating the care with which their loans should be serviced and refinanced, and repurchase loans from the GSEs; and (6) maintain hundreds of employees through retention payments so that delinquencies would not increase and thus diminish the value of, and jeopardize the sale of, the Debtors' MSRs and other assets. (Marano Direct ¶ 34.) For example, the Debtors needed to continue funding their servicing advance obligations for the RMBS and other PLS, as well as GSE loans. (*Id.* ¶ 35.) With respect to the GSE loans, the GSEs actually owned the Debtors' servicing rights, so if the Debtors failed to make the requisite advances, the GSEs could have revoked the Debtors' servicing rights, and re-assigned those rights to another company. (Marano Direct ¶ 35; Puntus Direct ¶ 19.)

The Debtors ultimately obtained DIP financing facilities from Barclays Bank PLC and AFI, as well as consensual use of cash collateral from their prepetition lenders, including the JSNs. (Marano Direct ¶ 37.) On May 14, 2012, the Debtors filed motions seeking authorization to (1) enter the Barclays postpetition financing facility (the "Barclays DIP Facility"); (2) make postpetition draws under the AFI LOC up to $200 million; and (3) use cash collateral securing each of the Revolver, the AFI LOC, and the Junior Secured Notes to fund the cash needs related to operations and assets of each of the respective collateral pools. (*Id.*; Puntus Direct ¶ 28.) The motions were approved on an interim basis on May 15, 2012, and were approved on a final basis, with the consent of the JSNs and AFI, pursuant to orders entered on ***572** June 25, 2012 (the "Cash Collateral Order"). (PX 76; Marano Direct ¶ 37.)

Under the Cash Collateral Order, the Debtors were authorized to use cash collateral in accordance with the Forecasts (as defined in the Cash Collateral Order), and the JSNs were protected to the extent of the aggregate diminution in value of the JSN Collateral. (PTO ¶ 29.) Among other things, the JSNs were granted adequate protection liens on all of the collateral securing the AFI Revolver, the AFI LOC, and all of the equity interests of the Barclays DIP Borrowers. (PX 76.)

The parties dispute whether, in determining an adequate protection claim based on diminution in value of collateral, the value of the collateral at the Petition Date should be determined by the foreclosure value of the collateral in the hands of the secured creditor (as argued by the Plaintiffs), or by the going concern value of the collateral in the hands of the Debtors (as argued by the Defendants). The legal issue is discussed below in section III.B.3. The Defendants' expert Mr. Siegert testified that when negotiating the Cash Collateral Order, the parties never discussed that adequate protection and diminution in value of JSN Collateral would be determined using foreclosure value. (Oct. 23 Tr. 195:9–13.) According to Mr. Siegert, that would have been contrary to the spirit of the negotiations, which were aimed at easing the Debtors' bankruptcy filing. (DX AIJ at 7.)

The Forecasts provided for the pro rata allocation of the cash disbursements during the relevant period to various silos of assets securing the Debtors' various secured credit facilities, as well as to unencumbered assets. (Puntus Direct ¶ 26.) The Debtors delivered updated Forecasts to the JSNs and AFI every four weeks as required by the Cash Collateral Order, and, although the JSNs did not have consent rights, at no point during the case did they object to any Forecast. (*Id.*) The Cash Collateral Order also obligated the Debtors to deliver to the JSNs a 20–week forecast of anticipated cash receipts and disbursements for the 20–week period. (PX 76 at 22.) The Debtors were only permitted to use cash collateral for the "purposes detailed within the Initial 20–Week Forecast and each subsequent Forecast." (*Id.* at 23–24.)

The Cash Collateral Order contained a waiver of the Debtors' right to surcharge against prepetition collateral pursuant to Bankruptcy Code section 506(c). (PX 76 at 42–43.) Specifically, the Cash Collateral Order states that: "[N]o expenses of administration of the Chapter 11 Cases or any future proceeding that may result therefrom, including liquidation in bankruptcy or other proceedings under the Bankruptcy Code, shall be charged against or recovered from the Prepetition Collateral and [Cash] Collateral pursuant to sections 105 or 506(c) of the Bankruptcy Code...." (*Id.*) The Cash Collateral Order also expressly waived the "equities of the case" exception contained in section 552(b) of the Code. (*Id.* at 35.)

The Debtors negotiated several extensions regarding the use of the cash collateral of AFI and the JSNs, including a stipulation entered on June 28, 2013. (ECF 12–12020 Doc. # 4115.) On July 10, 2013, the Court entered the Stipulation and Order in Respect of the Debtors' Motion for Entry of an Order to Permit the Debtors to Continue Using Cash Collateral (ECF 12–12020 Doc. # 3374) (the "Cash Collateral Stipulation") among the Debtors, AFI, and the JSNs, which terminated the use of cash collateral effective as of July 11, 2013, with certain limited exceptions. (PX 85 ¶ 2.)

The Debtors also negotiated a "Carve Out" in the Cash Collateral Order (PX 76 ***573** at 31– 32.) The Cash Collateral Stipulation served as the Carve Out Notice. No party disputes that a section 506(c) waiver was provided for the benefit of the JSNs. The parties dispute whether the JSNs are entitled to an adequate protection claim for amounts of cash collateral expended by the Debtors consistent with the agreed budget under the Cash Collateral Order. The issue also remains whether the Debtors may use an additional $143 million of the JSNs' cash collateral covered by the Carve Out in the Cash Collateral Order after the termination of the use of cash collateral where sufficient unencumbered cash is available to make the payments. The issue is addressed below in section III.D.8.

E. Stipulation of Liens under the Cash Collateral Order

In the Cash Collateral Order, the Debtors stipulated that the JSNs' collateral included, but was not limited to, all categories of assets identified in the "Ally Revolver" and "Blanket" columns on Exhibit A to the Cash Collateral Order. (PTO ¶ 28.) The Debtors further stipulated, pursuant to paragraph 5(g) of the Cash Collateral Order, that security interests granted to the JSNs "are valid, binding, perfected and enforceable priority liens on and security interests in the personal and real property constituting 'Collateral' under and as defined in the Junior Secured Note Documents." (PX 76 at 11–12.) Under the Cash Collateral Order, the "Junior Note Documents" included the JSN Security Agreement, the Notes Indenture, "and all other documents executed in connection therewith." (*Id.* at 4) The Defendants contend that, under paragraph 5(g), the Debtors stipulated that the JSNs' liens extend to all collateral to which a security interest was initially granted, including the AFI LOC Collateral that was previously released by the Third Priority Collateral Agent under the Blanket Release. (PTO JSN Contentions ¶ 18.) The JSNs' witness, Mr. Siegert—the lead engagement partner for Houlihan Lokey Capital, Inc. ("Houlihan")—testified that as of the Petition Date, he had no belief that the Debtors' stipulations in paragraph 5(g) would revive the JSNs' previously released liens. (Oct. 23 Tr.

102:4–6, 102:19–24, 105:3–25, 115:4–8, 125:12–126:15, 126:23–127:21.) Mr. Siegert explained that if counsel for the JSNs had concluded that paragraph 5(g) would revive more than $1 billion of AFI LOC Collateral, that would have been material information for Houlihan and the Ad Hoc Group to know, as well as a material factor in estimating the value of the JSNs' liens. (Oct. 23 Tr. 127:25–128:16.) But Houlihan's May 14, 2012 public presentation (the "May 14 Presentation") that presented an estimation of the JSNs' recovery on their prepetition collateral did not incorporate or disclose the existence of the billion dollars of AFI LOC Collateral. (PX 169; Oct. 23 Tr. 128:17–21; 132:18–133:4.) Mr. Siegert testified that if Houlihan had known that paragraph 5(g) revived $1 billion worth of JSNs' liens, it would have incorporated that fact in the May 14 Presentation. (Oct. 23 Tr. 128:23–133:4.)

Further, in paragraph 5(g), the Debtors stipulated that the JSNs' liens are "subject and subordinate only" to those prepetition liens that were granted under the Revolver. (PX 76 at 11–12.) But this provision does not subordinate the JSNs' purported lien on the AFI LOC Collateral to AFI (i.e., the lender). So under the Defendants' proposed interpretation of paragraph 5(g), the JSNs' purported liens on the AFI LOC Collateral would be elevated ahead of the AFI's liens in that same collateral. Additionally, while granting the JSNs a postpetition adequate protection lien on the Revolver Collateral and the ***574** AFI LOC Collateral, the Cash Collateral Order subordinated those liens to any existing liens on the same collateral. To that end, with respect to the JSNs' adequate protection lien on the Revolver Collateral the Order acknowledges that the lien is junior to the "existing liens granted to the Junior Secured Parties." (*Id*. at 28.) With respect to AFI LOC Collateral, though, the Cash Collateral Order does not mention the JSNs' purported existing lien on that collateral. (*Id*. at 28–29.)

Other documents also indicate that paragraph 5(g) was not intended to revive any previously released JSN liens. For example, in the JSN PSA, the JSNs expressly reserved the right to make a claim for an equitable lien on the AFI LOC Collateral. (PX 252 § 5.6.) That would have been superfluous if the JSNs believed that paragraph 5(g) already granted them a lien on that collateral. Moreover, when the Debtors sought approval of the Barclays DIP Facility, they argued that any asserted equitable JSN lien on the AFI LOC Collateral was invalid and not perfected. (PX 88 at 55.) That position would have been inconsistent with a stipulation granting the JSNs a lien on that collateral in paragraph 5(g). Neither the motion for approval of the use of cash collateral, nor any disclosures to the Court in connection with the interim or final cash collateral orders, disclose that the JSNs believed they were getting a perfected security interest in any previously released collateral.

F. The Asset Sales

On the Petition Date, the Debtors filed motions to approve stalking horse bids from AFI and Nationstar with respect to the Debtors' Whole Loan Portfolio and Servicing and Origination Assets, respectively. (*See* PX 61.) The Debtors entered into the initial stalking-horse bid with Nationstar to sell the servicing, origination, and capital markets platforms (which included people, software, and IT) of the Debtors. (PX 33.) The Debtors also agreed to sell Nationstar contracts, servicing agreements, MSRs owned by the Debtors, certain Ginnie Mae-guaranteed whole loans, and intellectual property, goodwill, and general intangibles "Related to the Business" for $2.3 billion. (*Id*. at 38–41.)

After the Petition Date, on June 15, 2012, Berkshire Hathaway, Inc. ("Berkshire") submitted competing bids to become the stalking horse bidder for both sets of assets. (Puntus Direct ¶ 59.) The bids, which were submitted without Berkshire having performed any due diligence, were in the form of executed asset purchase agreements virtually identical to the agreements executed by Nationstar (for the Servicing and Origination Assets) and AFI (for the Whole Loan Portfolio). (*Id*.) Due, at least in part, to Berkshire's bids, a "pre-auction" auction (the "Mini Auction") ensued in advance of and during the sale procedures hearing, with the Court ultimately directing that final proposed stalking horse bids be submitted to the Debtors on June 18, 2012. (*Id*.) In accordance with the Court's direction, both Nationstar and Berkshire submitted revised stalking horse bids. (*Id*.) With the support of the Committee, the Debtors sought and obtained Court approval of the Nationstar and Berkshire stalking horse bids and the bid and sales procedures at a hearing on June 19, 2012.[23] (*Id*. ¶ 60.)

23 The Mini Auction resulted in increases in the sales prices by a total of $150 million, as well as a reduction in the proposed break-up fees for the origination and servicing platform.

In the lead-up to the Asset Sales, the Debtors maintained the servicing and origination ***575** platforms as going concerns. (Marano Direct ¶¶ 50–51.) The Debtors considered, but rejected, the possibility of liquidation, because, according to Mr. Marano, the Debtors did not believe that a liquidation was in the best interests of the creditors, and the Debtors did "everything [they] could" to prevent a foreclosure. (Oct. 15 Tr. 164:10–25.)

1. The Servicing and Origination Assets Sale

The Court approved the sale and bid procedures with respect to the Servicing and Origination Assets (PX 44), and Centerview approached those institutions that it believed would have an interest in purchasing, and the financial resources and expertise necessary to purchase, the Servicing and Origination Assets, to gauge their respective interest. (Puntus Direct ¶ 61.) Following these initial contacts and an introductory due diligence period for interested parties, the Debtors' management team and Centerview made formal presentations to five prospective purchasers, during which they described in detail the Servicing and Origination Assets being sold and afforded them an opportunity to visit the Debtors' locations and perform detailed on-site due diligence with the Debtors' business units. (*Id.*) The Debtors received responses from three potential purchasers: (1) Berkshire, (2) a consortium of two bidders, and (3) a consortium composed of Ocwen and Walter Investment Management Corporation ("Walter"). (*Id.* ¶ 63.) The Debtors focused their marketing efforts on these three potential purchasers. (*Id.*)

On October 19, 2012, the Debtors received two qualifying bids for the Servicing and Origination Assets: (1) the stalking horse bid previously submitted by Nationstar at a value of $2.357 billion; and (2) a bid from Ocwen and Walter at a value of $2.397 billion. (PX 48; PX 47.) The Debtors determined that the Ocwen bid was the highest and best bid for the Servicing and Origination Assets and decided that they would open the auction with the Ocwen bid. (Puntus Direct ¶ 64; PTO ¶ 34.) On October 23, 2012, the Debtors began the auction for the Servicing and Origination Assets with Ocwen's bid as the opening bid. Two bidders, Nationstar and Ocwen, submitted offers for these assets. Although Ocwen was a bidder of record for these assets, the Ocwen APA provided for the assignment of the Debtors' Fannie Mae assets to Walter. (PX 47; Puntus Direct ¶ 69.)

During the auction, the Debtors negotiated with Nationstar and Ocwen to obtain certain adjustments to their bids and asset purchase agreements. As required by Ginnie Mae, both bidders agreed to remove the Ginnie Mae liability bifurcation condition in the asset purchase agreements. (Puntus Direct ¶ 71.) Consequently, Ginnie Mae would be able to seek satisfaction of all liabilities relating to Ginnie Mae loans, either pre- or post-closing, related to servicing or origination, from the purchaser of the Servicing and Origination Assets. (*Id.*) Also, although both Ocwen's and Nationstar's bid did not contractually obligate them to acquire the servicing and origination platforms, both bidders agreed to include a commitment to acquire the platforms and associated liabilities as part of the bid. (Puntus Direct ¶ 72; Marano Direct ¶ 62.) To induce Ocwen and Nationstar to make this commitment, the Debtors offered the bidders a bid credit in the amount of $108.4 million, which represented the estimated liabilities associated with the platforms. (PX 56 at 37–41; Puntus Direct ¶ 72.) After 28 rounds of bidding, Ocwen made the highest and best offer to purchase the Debtors' Servicing and Origination Assets for itself and Walter, with a winning purchase price of approximately ***576** $3 billion. (PX 57 at 9–10.) The Court approved the Ocwen Sale on November 19, 2012, and entered an Order approving the asset sales on November 21, 2012. (PX 45; Puntus Direct ¶ 79; PTO ¶ 36.)

The parties effectuated the Ocwen Sale through the Ocwen APA, dated as of November 2, 2012 (and as later amended), among Ocwen, ResCap, and certain other Debtor signatories. (PX 19; PX 20; PX 21; PX 22; PX 23; PX 24; PTO ¶ 37.) The Ocwen APA provided that Ocwen was buying "goodwill and other intangible assets Related to the Business or related to the Purchased Assets." (DXPT at 41.) In total, over 2,000 ResCap employees, including those associated with call centers and management, were "migrat[ed]" to Ocwen as part of the purchase of ResCap's servicing and origination platform with no significant reduction in personnel. (Ziegenfuse Dep. 63:16–19:6, 65:7–21, 67:17–23.)

In the APA, Ocwen attributed zero value to goodwill and intangibles, but in a subsequent 10–Q filing, the company attributed approximately $210 million to those assets. (DX ZH at 30.) The APA contains a provision that any purchase price allocation in the APA would only bind the parties for tax purposes, and not for any other purpose. (PX 19 at 50.) The parties dispute

whether a portion of the purchase price must be allocated to general intangibles and goodwill, as to which the JSNs claim to have a perfected lien.

2. The Whole Loan Portfolio Sale

Contemporaneously with the marketing process for the Servicing and Origination Assets, Centerview considered those institutions that it believed would be interested in and financially capable of purchasing the Whole Loan Portfolio. (Puntus Direct ¶ 65.) Centerview approached those potential purchasers to gauge their respective interest. (*Id.*) On October 19, 2012, the bid deadline approved by the Court, the Debtors received two qualifying bids for the Whole Loan Portfolio: (1) the stalking horse bid previously submitted by Berkshire at a value of $1.324 billion; and (2) a bid from a consortium of four financial bidders led by DLJ Mortgage Capital (the "DLJ Consortium") at a value of $1.339 billion. (*Id.* ¶ 66) The Debtors determined that the DLJ Consortium bid was the highest and best bid for the Whole Loan Portfolio and decided that they would open the auction with the DLJ Consortium bid. (*Id.*; PTO ¶ 35.)

On October 25, 2012, ResCap held an auction for its Whole Loan Portfolio. (Puntus Direct ¶ 79.) After 11 rounds of bidding, Berkshire won the auction with the highest and best offer of $1.5 billion, an amount $175 million higher than the original stalking horse bid. (*Id.*; PX 58 at 22–23.) Before the auction, Berkshire had agreed to continue compliance with certain aspects of the FRB Consent Order and the DOJ/AG Settlement. (Puntus Direct ¶ 79.) The Court approved the Berkshire sale on November 19, 2012, and entered an order approving the asset sales on November 21, 2012. (ECF 12–12020 Doc. # 2247; PX 46.)

G. Facts related to Original Issue Discount

The Junior Secured Notes were issued in connection with a 2008 debt-for-debt exchange offering (the "Exchange"). On May 5, 2008, ResCap issued an Offering Memorandum in which it offered to exchange $9.537 billion face value amount of its then-outstanding unsecured notes maturing from 2010 through 2015 (the "Old Notes") for the Junior Secured Notes. (PTO ¶ 7; PX 175.) Under the Exchange, ResCap offered to exchange $1,000 face principal amount of outstanding unsecured notes for $800 face value of Junior Secured ***577** Notes. (PTO ¶ 8.) Pursuant to a modified Dutch Auction, the clearing price was $650 per $1,000 principal amount of Junior Secured Notes, which was the lowest level at which tenders were accepted. (*Id.*) Through the Exchange, ResCap exchanged approximately $6 billion of Old Notes for approximately $4 billion in Junior Secured Notes and $500 million in cash. Approximately 63% of the Old Notes were exchanged in the Exchange. (*Id.* ¶ 9.) The issue price of the Junior Secured Notes was established as $613.75 based on trading activity from the first day of trading. Using this price, AFI calculated the amount of OID for tax purposes as of the Petition Date to be $377,262,728. (*Id.* ¶ 52; PX 189; Finnerty Direct ¶ 55.) As an economic matter the Exchange created OID. (Finnerty Direct ¶ 10.) AFI amortized the OID by compounding it on a semi-annual basis. Amortizing OID on a daily compounding basis results in a slightly larger amount of OID: $386 million. (*Id.* ¶ 60.)

The Plaintiffs argue that the OID should be disallowed in bankruptcy as unmatured interest. The Defendants, on the other hand, argue that the OID should be allowed as part of their claim based on Second Circuit precedent. The Plaintiffs and Defendants each offered expert testimony on issues relating to the bankruptcy treatment of the OID generated in the Exchange. John D. Finnerty, Ph.D., a Managing Director in the Financial Advisory Services Group at AlixPartners, LLP and Professor of Finance at Fordham University's Graduate School of Business Administration, testified on behalf of the Plaintiffs, and Mr. Siegert testified on behalf of the Defendants.

The parties do not dispute that the Exchange was a "fair value" exchange—*i.e.*, that old securities were exchanged for new securities with a reduced principal amount that in theory approximated the market value of the old securities. The Second Circuit's decision in *LTV Corp. v. Valley Fidelity Bank & Trust Co. (In re Chateaugay Corp.),* 961 F.2d 378 (2d Cir.1992), addressed the bankruptcy treatment of OID generated in connection with a "face value" exchange—*i.e.*, one in which the principal amount of the debt is not reduced.[24] (Finnerty Direct ¶ 102; Oct. 21 Tr. 151:11–14.) The experts also agreed that

investors in the Notes were sophisticated investors who understood how to analyze risks associated with investing in OID bonds. (Finnerty Direct ¶ 92; Oct. 21 Tr. 184:8–11.)

24 The Second Circuit explained the distinction between the two types of exchanges, writing:

> An exchange offer made by a financially troubled company can be either a "fair market value exchange" or a "face value exchange." In a fair market value exchange, an existing debt instrument is exchanged for a new one with a reduced principal amount, determined by the market value at which the existing instrument is trading. By offering a fair market value exchange, an issuer seeks to reduce its overall debt obligations.... A face value exchange, by contrast, involves the substitution of new indebtedness for an existing debenture, modifying terms or conditions but not reducing the principal amount of the debt.

Chateaugay,961 F.2d at 381–82 (citations omitted).

In addition, Dr. Finnerty calculated that using semi-annual compounding, $377 million in OID remained unamortized as of the Petition Date. (Finnerty Direct, App'x 6A.) Dr. Finnerty, though, believed that daily compounding was the more appropriate method, which he calculated to yield $386 million of unamortized OID as of the Petition Date. (*Id*. at App'x 6B.) Mr. Siegert, on the other hand, testified that he believed that semi-annual compounding ***578** was the best method. (*See* Oct. 21 Tr. 163:21–25.)

Dr. Finnerty stressed the economic incentives built into the Exchange: yield, security, and seniority. (Finnerty Direct ¶ 62.) In addition, the Exchange allowed ResCap to reduce its overall debt obligations and extend its debt maturities, thereby enhancing the credit strength of the JSNs' obligor, allowing ResCap to avoid bankruptcy for four more years. (*Id*.) In fact, the JSNs will achieve a greater recovery than the noteholders who did not exchange and whose notes remained outstanding on the Petition Date. The Debtors Disclosure Statement (ECF 12–12020 Doc. # 4811) indicates that while the hold-outs have retained a $1,000 par amount unsecured claim, they are projected to recover only 36.3%, or $363.00. (Finnerty Direct ¶ 88.) In contrast, the holders of the JSNs, who received $800 of new secured notes in June 2008, are projected to recover $840. (*Id*.) The Exchange was attractive—and future exchanges could likewise be attractive regardless of the bankruptcy treatment of OID—because of the competitive effective yield of the Junior Secured Notes at issuance, the fact that the Junior Secured Notes, unlike the Old Notes, were secured, and the fact that the Junior Secured Notes were structurally senior to the Old Notes. (*Id*. ¶¶ 62–67, 93.)

Mr. Siegert, in contrast, testified, among other things, that: (1) the disclosures made by ResCap in the Exchange, along with general market evidence, are inconsistent with the conclusion that the Exchange generated disallowable OID for bankruptcy purposes; and (2) disallowing OID in fair value exchanges such as the Exchange would likely cause debt-holders to either reject such exchanges or demand more from distressed companies, thereby discouraging out-of-court workouts and leading to a greater number of bankruptcies. (Siegert Direct ¶ 30.) Mr. Siegert noted that the disclosures did not warn that the Exchange could create OID that would be disallowed in bankruptcy. (*Id*. ¶ 31.) Mr. Siegert also testified that the market did not place much value on the structural enhancements to the Notes that the Exchange created since 63% of noteholders participated in the Exchange, which was a lower participation rate than typical debt-for-debt exchanges. (*Id*. ¶ 32.) ResCap was expecting a significantly higher level of participation in the Exchange; the company and its advisors originally projected a base case participation level of 76%. (*See* Hall Dep. 53:10–21.)

If ResCap had not executed the Exchange, the Company would not have had an ability to meet its debt service obligations as they came due without some third party intervention. (Hall Dep. 43:10–16.) The successful completion of the Exchange enhanced shareholder value by reducing the amount of the Company's outstanding debt. (Hall Dep. 55:14–23; Oct. 21 Tr. 64:5–8; 64:25–65:2.) The successful completion of the Exchange also provided ResCap, its creditors, and other stakeholders with several other valuable benefits, including reducing ResCap's debt service and extending the maturities on ResCap's outstanding debt. (DX BB at 13; Oct. 21 Tr. 18:10–14; 63:6–15; 64:5–8.)

Both experts testified that there is little difference between a face value exchange and a fair value exchange, making disparate treatment for the two exchanges in bankruptcy economically illogical. (Siegert Direct ¶ 37; Oct. 21 Tr. 67:10–69:9.) Mr. Siegert explained that both fair and face value exchanges offer companies the opportunity to restructure out-of-court, avoiding the time and costs—both direct ***579** and indirect—of a bankruptcy proceeding. (DX AIJ at 7.)

The Second Circuit treats OID created by face value exchanges as allowable in bankruptcy, despite the Code's provision that unmatured interest is disallowed. *See Chateaugay,* 961 F.2d at 384. The *Chateaugay* decision left open the possibility that fair value exchanges could be treated differently, but it did not resolve the issue. Both Dr. Finnerty and Mr. Siegert acknowledged that under *Chateaugay,* there would be no disallowable OID here if the Junior Secured Notes were issued at 100% face value, and all other inducements for participation remained the same. (Oct. 21 Tr. 136:9–20; 214:2–4.) Dr. Finnerty and Mr. Siegert also both acknowledged that if creditors knew that OID created in fair value exchanges would be disallowed, distressed issuers would need to offer greater incentives to participate. (Siegert Direct ¶ 3 8; DX ABC; Oct. 21 Tr. 101:15–17.) According to Mr. Siegert, this would make distressed debt exchanges more difficult and would likely lead to more bankruptcy filings as opposed to out-of-court workouts. Additionally, bondholders could simply reject fair value exchanges altogether. (Siegert Direct ¶ 3 8.) The experts also both testified that they are unaware of any other creditors whose claim would be determined in bankruptcy based on the trading prices of bonds used to determine the issue price. (DX AIJ 10; Oct. 21 Tr. 23:20–24:2.) Thus, a holder of the Old Notes would not know the amount of OID that would be disallowed in bankruptcy before tendering. (Oct. 21 Tr. 50:24–51:21.) The legal analysis of OID is found in section III.A below.

H. The Paydowns

On or about June 13, 2013, the Debtors made a payment in the amount of $800 million on account of the outstanding principal of the Junior Secured Notes. (*See* ECF Doc. # 3967.) On or about July 30, 2013, the Debtors made an additional $300 million payment on account of the outstanding principal of the Junior Secured Notes. (*See* ECF Doc. # 4404.) Together these repayments reduced the outstanding principal balance by $1.1 billion.

I. Expert Valuations of JSN Collateral on Petition Date

The JSNs offered valuation testimony from four proposed experts affiliated with Houlihan: Messers. Fazio, Levine, Taylor, and Siegert. Mr. Fazio offered opinions on the Petition Date value of the Debtors' sold and unsold HFS assets and certain other unsold assets. (Fazio Direct ¶¶ 2–3; Oct. 22 Tr. 122:10–13.) He also offered an opinion on the Petition Date value of a hypothetical entity consisting solely of the Debtors' MSRs, servicing operations, and originations platform. (Fazio Direct ¶¶ 2, 7; Oct. 22 Tr. 122:14–16.) Mr. Levine offered opinions on the Petition Date value of the Debtors' MSRs, refinancing opportunities associated with the MSRs, and Servicing Advances. (Levine Direct ¶ 2.) Mr. Taylor offered an opinion on the allocation of value to certain assets associated with the Ocwen asset sale, including intangible assets, goodwill, and liabilities acquired by Ocwen and Walter. (Taylor Direct ¶¶ 2–3, 7.)

Mr. Siegert offered a single "Global Summary" of these Houlihan opinions suggesting the net fair market value of the JSN Collateral on the Petition Date totaled $2.79 billion. (Siegert Direct ¶¶ 4, 25; Oct. 23 Tr. 134:1–14, 141:14–142:6; DX ABF at 10.) He arrived at this value by first summing (1) the valuations of the Debtors' cash, HFS assets, unsold servicing advances, FHA/VA loans, equity interests, hedge contracts, and certain other contracts; (2) the valuation of the Debtors' ***580** sold servicing advances; and (3) his own valuation of the Debtors' intangible assets, derived from his own analysis of Messrs. Fazio, Taylor, and Levine's valuations. (DX ABF at 9–10.) This totaled $4.450 billion. (*Id.* at 10.) Mr. Siegert then subtracted $747 million owed to Ally on the Ally Revolver, and $912 million owed on two facilities,[25] to reach $2.791 billion. (Siegert Direct ¶ 25 & n. 6; DX ABF at 10.)

25 The GMAC Mortgage Services Advance Funding Company Ltd. ("GSAP") Facility and the BMMZ Holding LLC Facility.

The Houlihan experts' valuation assumes that the assets could have been sold on the Petition Date by the Debtors. (Oct. 22 Tr. 139:18–142:4; Oct. 23 Tr. 147:23–149:3, 149:18–22.) But when valuing the assets, the Defendants' experts did not look to sales conducted by other distressed entities on the brink of insolvency; rather, the experts treated ResCap as a solvent seller able to capture fair value for its assets.

The Plaintiffs, on the other hand, offered the opinion of Mr. Puntus, Partner and Co–Head of the Restructuring Group at Centerview. Mr. Puntus has been the lead investment banker for the Debtors for over two years. (Puntus Direct ¶ 1, 16; Oct.

16 Tr. 98:9–16.) He was heavily involved in the Debtors' decision to market their assets, the prepetition marketing process and the postpetition sale process, serving as the lead business negotiator for the Debtors on the stalking horse agreements as well as the auction process. (Oct. 16 Tr. 97:23–98:16, 103:6–9.)

Mr. Puntus used the initial Nationstar and AFI stalking horse agreements to determine the benchmark value in his analysis ($1.736 billion), even though these agreements were never consummated. He also endeavored to estimate what the JSNs' Collateral would have been worth upon foreclosure, where the disposition of the assets would have been controlled, in the first instance, by the First Priority Collateral Agent (directed by AFI) or the lenders (*i.e.*, Barclays and AFI for GSAP and BMMZ, respectively).

Mr. Puntus's benchmark did not represent his opinion of the value of the JSNs' Collateral for purposes of adequate protection because the purchase prices reflected in the stalking horse deals were contingent upon the continued operation of the Debtors' business in chapter 11 (Oct. 16 Tr. 103:10–22.) To estimate the value of the JSNs' Collateral as of the Petition Date in the hands of the creditors' agents upon foreclosure, Mr. Puntus therefore made certain downward adjustments from his benchmark valuation. Mr. Puntus based these adjustments on two alternative scenarios, differing in how long he assumed the creditors would take to dispose of the collateral: "Alternative A" assumed the collateral would be monetized by the collateral agents over a three to four month time period ($1.474 billion), while "Alternative B" assumed a five to six-month period ($1.594 billion). (Puntus Direct, ¶¶ 86–88.) Mr. Puntus further made reductions to account for RMBS and government set off risks, which reduced the "Alternative A" valuation to $1.046 billion, and the "Alternative B" valuation to $1.13 5 billion. (Puntus Direct Ex. 1 at 9.)

Mr. Puntus's methodology was dependent upon his subjective valuations of risks associated with the collateral. At trial, Mr. Puntus conceded that he had never seen a valuation analysis relying on similar methodology before. (Oct. 16 Tr. 36:6–8.) Nor is it likely that Mr. Puntus's valuation methodology could be used in other contexts. ***581** While Mr. Puntus's methodology is unsupportable, the numbers he reached may well be closer to the actual value of the JSN Collateral on the Petition Date.

J. Effective Date Value of JSN Collateral

The parties agree to a value of $1.88 billion as the baseline valuation for the JSNs' collateral as of December 15, 2013 (the assumed "Effective Date"), but the Debtors contend that only $1.75 billion of that collateral is properly distributable to the JSNs. The Plaintiffs seek to reduce the JSNs' potential recovery by assessing $143 million of expenses under the Carve Out against the JSN Collateral. The Plaintiffs argue that the Cash Collateral Order expressly made the JSNs' liens subordinate to the Carve Out. The Defendants countered that the Plaintiffs should use unencumbered cash to pay the Carve Out rather than JSN cash collateral.

1. Deposit Accounts

Except for the Controlled Accounts (defined below), the Deposit Accounts listed on Schedule 5 to the Committee Action are not subject to an executed control agreement among the relevant Debtor, the Third Priority Collateral Agent, and the bank where such Deposit Accounts are maintained. (PX 126; Landy Direct ¶¶ 3(d), 24(a), 40.) The uncontroverted evidence at trial established that, as of the Petition Date, the Deposit Accounts held funds in the amount of $48,502,829. (Landy Direct ¶ 41.)

Executed control agreements were admitted into evidence for the following Deposit Accounts (collectively, the "Controlled Accounts"): Account Nos. xxxx7570, xxx6190, xxx8567, xxxx7618, xxxx2763, and xxxx0593. (*See* DX AIU; DX AIV; DX AIW; DX AIX; DX AIY; DX AIZ.) As of the Petition Date, the Controlled Accounts held an aggregate amount of $16,885. (PX 126.) Deposit Account Nos. xxxx2607, xxxx7877, and xxxx1176 (collectively, the "WF Accounts") are maintained at Wells Fargo, which is the Third Priority Collateral Agent. The WF Accounts contained $38,321 as of the Petition Date. (PX 126.)

Deposit Account Nos. xxxx3803 and xxxx6323 (together, the "Ally Accounts") are maintained at Ally Bank, which is an indirect, wholly-owned subsidiary of the AFI, the Revolver Lender. (PTO JSN Contentions ¶ 103.) Ally Bank is not a party to the Junior Notes Documents, the Revolver Documents or the Intercreditor Agreement and is therefore not a "secured party" within the meaning of the U.C.C. for purposes of control and perfection. Further, the Third Priority Secured Parties are not perfected by virtue of the Revolver Lender and Ally Bank being affiliates. First, given that they are not the same entity, the Revolver Lender's lien is not perfected under the U.C.C. through automatic control. Second, even if AFI's lien were perfected through automatic control, that would be the case only with respect to its own security interest (under the Revolver).

Deposit Account No. xxxx2599, which is maintained at J.P. Morgan Chase Bank, N.A. and contained $8,091 as of the Petition Date, contains proceeds of the JSN Collateral (the "Proceeds Account"). (Oct. 17 Tr. 173:4–174:11; PX 6 at 18–19.) The Court finds that the Third Priority Secured Parties have a perfected interest in that account under the U.C.C. because it contains proceeds of JSN Collateral. The Defendants failed to proffer evidence at trial that any of the Deposit Accounts other than the Proceeds Account contain proceeds of the JSN Collateral.

2. Real Property

Various Debtors owned the real property and leasehold interests listed on Schedule ***582** 2 to the Committee Action, and that portion of Schedule 6 to the Committee Action that identifies REO properties (*i.e.*, mortgaged properties acquired through foreclosure or other exercise of remedies under mortgages or deeds of trust that secured the associated mortgage loan instruments) as of the Petition Date. The property and leasehold interests are not subject to either a mortgage or a deed of trust in favor of the Third Priority Collateral Agent (the "Unencumbered Real Property"). (PX 124; PX 127 at 44–47; Landy Direct ¶¶ 3(b), 24(b), 36; Oct. 17 Tr. 175:1–23.) The uncontroverted evidence at trial established that, as of the Petition Date, the fair market value of the Unencumbered Real Property was $21 million. (Landy Direct ¶ 38.)

The Third Priority Collateral Agent did not know whether it had received any mortgage or deed of trust with respect to the Unencumbered Real Property, nor did it know whether any property owner ever granted or signed a mortgage or deed of trust with respect to the Unencumbered Real Property. (Pinzon Dep. 24:7–11, 29:2–11.) No mortgage or deed of trust for the Unencumbered Real Property was proffered by any party or admitted into evidence during the trial. (Landy Direct ¶ 37.)

The JSNs, therefore, do not have a perfected security interest in or lien on any of the Unencumbered Real Property because that property was not subject to an executed and filed mortgage or deed of trust.

3. Executive Trustee Services, LLC and Equity Investment I, LLC Assets

The Plaintiffs argue that the JSNs do not have liens on assets of Executive Trustee Services, LLC ("ETS") and Equity Investment I, LLC ("Equity I"). According to the Plaintiffs, ETS pledged all of its assets to the Revolver in February 2011, but did not pledge any assets to the JSNs. The Plaintiffs also claim that any security interest in Equity I was released on December 29, 2009.

On February 16, 2011, ETS executed a joinder to the Revolver Documents and pledged all of its assets to AFI under the Revolver as a guarantor. Neither the Debtors nor the JSNs have identified a similar joinder agreement whereby ETS became an obligor under any of the Notes Agreements or granted any security interest to the Noteholders. The JSNs have argued that Section 4.17 of the Notes Indenture and Section 2.3(c) of the Intercreditor Agreement dictate that ETS is a guarantor of the Junior Secured Notes. Section 4.17 of the Notes Indenture provides the process by which future guarantors execute supplemental indentures guaranteeing the Junior Secured Notes, and Section 2.3(c) of the Intercreditor Agreement provides that any party pledging assets to the Revolver must also pledge such assets to the JSNs. (PX 1 at 59–60; PX 2 at 17.) But these provisions are not self-effectuating, and ETS was not a party to the Intercreditor Agreement. Absent an indication that ETS actually did pledge assets to the JSNs, the JSNs cannot establish a lien on any ETS assets.

As for Equity I, that entity was an obligor under the Original Revolver Loan Agreement and the Original JSN Security Agreement, but it was removed as an obligor in the amended versions of those agreements. (PX 3; PX 4; PX 5; PX 6; PX 7; PX 8.) Further, On December 29, 2009, the Third Priority Collateral Agent executed a U.C.C.–3 termination statement terminating the security interest in all assets pledged by Equity I. (PX 131 at 841–45.) The next day, the parties executed the amended JSN Security Agreement that removed Equity I as an obligor. (PX 4.) Also on December 30, 2009, Equity I became a guarantor under the AFI LOC. ***583** (PX 9.) The JSNs therefore do not have a lien on any Equity I assets.

4. Reacquired Mortgage Loans

Count IV of the Committee' complaint alleges that the JSNs do not have perfected security interests in certain mortgage loans that were (1) released from the JSNs' liens and security interests in May 2010 to be sold to certain Citi and Goldman Repurchase Agreement Facilities ("Repo Facilities"), and (2) subsequently repurchased by the Debtors between September 2010 and the Petition Date (the "Reacquired Mortgage Loans"). As of the Petition Date, the Debtors owned the Reacquired Mortgage Loans, which were coded as "Blanket Lien Collateral" in the CFDR. The Debtors repurchased the majority of the Reacquired Mortgage Loans in January 2012. (*See* DX ABM, Schedule 1.) The Committee's complaint alleges that the Reacquired Mortgage Loans total approximately $14 million at book value and $10 million at fair value. (PX 125; PX 241 at 9.)

Wells Fargo, acting in its capacity as the Third Priority Collateral Agent, filed U.C.C.–3 financing statement amendments in May 2010 terminating the JSNs' security interests in, among other things, loans that later became the Reacquired Mortgage Loans. (*See, e.g.*, PX 133; PX 136.) Those U.C.C.–3 amendments made clear that the assets that were subject to the release were being sold to Repo Facilities by expressly referencing the Repo Facilities and identifying the assets subject to the U.C.C.–3 amendments as the Mortgage Loans listed on certain Schedules to the Repo Facilities. (*See, e.g.*, PX 133; PX 136.) The loans listed on the U.C.C.–3 amendment were within the scope of and were covered by preexisting U.C.C.–1 financing statements. The U.C.C.–3 amendments provided notice of a collateral change, not a termination of the effectiveness of the identified financing statement. (*See, e.g.*, PX 133; PX 136.)

The U.C.C.–1 financing statements, which remained in effect notwithstanding the filing of the U.C.C.–3 financing statements, continued in force and operated to perfect the JSNs' security interests in the Reacquired Mortgage Loans after the Debtors repurchased those loans. (*See, e.g.*, PX 132; PX 4 § 2.) The U.C.C.–1 financing statements and U.C.C.–3 amendments filed by Wells Fargo provided notice to any potential lender seeking to obtain a security interest in the Reacquired Mortgage Loans of the possibility that the JSNs held a perfected security interest therein. Any potential lender inquiring about the collateral (1) could learn that the Reacquired Mortgage Loans had been reacquired by the Debtors subsequent to the filing of the U.C.C.–3 amendments (by virtue of the fact that they were owned by the Debtors); and (2) would have access to the U.C.C.–1 financing statements providing that the JSNs held a perfected security interest in all assets that the Debtors subsequently acquired. (Oct. 23 Tr. 36:5–37:19.)

Had any actual or potential unsecured creditor inquired of ResCap into the status of the Reacquired Mortgage Loans prepetition, that creditor would have learned that the loans were once again subject to AFI's and the JSNs' Blanket Lien, which was reflected in the CFDR. (*See* Farley Dep. 95:3–14, 110:5–111:14, 115:4–14, 137:21–24, 138:4–11, 176:21–177:3, Oct. 16 Tr. 190:21–192:18; Hall Dep. 117:6–12; Ruhlin Dep. 65:19–22, 66:6–21, 106:8–12, 119:4–9, 155:16–156:2, 156:15–21.)

Therefore, the Court finds that the Reacquired Mortgage Loans are properly treated as collateral for the JSNs at the Petition Date.

584** ***5. Excluded Assets

Count I of the Committee's complaint alleges that, pursuant to the JSN Security Agreement, the JSNs do not have perfected security interests in assets that were (1) pledged to a Bilateral Facility (as defined by the JSN Security Agreement) on the date that the Junior Secured Notes were issued by ResCap, (2) subsequently released from the applicable Bilateral Facility prior to May 14, 2012 (the "Petition Date"), and (3) owned by the Debtors on the Petition Date and coded as "Blanket Lien Collateral" (the "Former Bilateral Facilities Collateral").[26] The Plaintiffs' expert Mr. Landy valued the Former Bilateral Facilities Collateral at $24 million as of the Petition Date using fair market valuation. (*See* PX 241 at 9.)

26 The "Former Bilateral Facilities Collateral" is referred to as "Released Bilateral Facilities Collateral" in the Committee's complaint and briefings by the Plaintiffs.

On June 6, 2008, Wells Fargo, acting in its capacity as the Third Priority Collateral Agent, filed U.C.C.–1 financing statements indicating that the JSNs held a security interest in "[a]ll assets [of each grantor] now owned or hereafter acquired and wherever located." (PX 132.) Section 2 of the JSN Security Agreement (the "All–Assets Granting Clause") reaches all of the Debtors' assets that are legally and practicably available both at the time, and after, the JSN Security Agreement was executed. (PX 4 at 4–17, 18–19 (providing that the pledge includes assets "whether now or hereafter existing, owned or acquired and wherever located and howsoever created, arising or evidenced").)

The JSN Security Agreement carves out from the JSNs' Collateral certain assets (the "Excluded Assets") that could not be pledged to the JSNs for legal or business reasons. (PX 4 at 15–17 ("provided that, notwithstanding the foregoing, the 'Collateral' described in this Section 2 shall not include Excluded Assets.").) "Excluded Assets" are defined under the JSN Security Agreement as "(c) any asset ... to the extent that the grant of a security interest therein would ... provide any party thereto with a right of termination or default with respect ... to any Bilateral Facility to which such asset is subject as of the Issue Date [(June 6, 2008)]." (PX 4 at 4–15.) The Excluded Assets category included assets pledged to Bilateral Facilities as of the Issue Date, because the terms of the Bilateral Facilities precluded those assets from being pledged to the AFI Revolver or the JSNs. (Oct. 16 Tr. 184:24–185:3.)

The Court previously ruled that the JSN Security Agreement is ambiguous with respect to "whether an Excluded Asset becomes part of the Secured Parties' collateral pursuant to the All–Asset Granting Clause once it ceases to constitute an Excluded Asset." *Residential Capital,* 495 B.R. at 262. The Court therefore allowed the parties to present extrinsic evidence to determine the parties' intended meaning.

Ms. Farley, the Senior Director of Asset Disposition for ResCap, was involved in negotiating and implementing the Revolver. She testified that she understood that if the Bilateral Facilities had not precluded the Debtors' assets pledged thereunder from being pledged to AFI and the JSNs, and if those assets otherwise fell within the broad scope of the Blanket Lien, then the Debtors would have included those assets as Revolver and JSN Collateral. (Oct. 16 Tr. 184:24–185:12; Farley Dep. 26:7–18, 58:12–20, 65:13–66:2, 71:5–18.) She also testified that AFI and ResCap understood that the Excluded Assets would change over time. (Oct. 16 Tr. 182:13–21.)

Lara Hall of AFI testified at her deposition that:

***585** • "AFI's intent was as soon as the assets rolled off the bilateral facility, they would become subject to the blanket lien." (Hall Dep. 123:19–23; *see also id*. 119:7–15);

• at the time the original AFI Revolver and Revolver Security Agreement were negotiated, in exchange for funding the AFI Revolver, AFI was "trying to secure whatever remained unencumbered that we could, that was legally available to be pledged, not an excluded asset and was operationally feasible for the company, being ResCap." (Hall Dep. 106:2–20; 113:2–13); and

• "[t]he blanket lien basically suggested that anytime an asset became uncovered, it would be subject to the blanket lien." (Hall Dep. 116:6–14.)

Joseph Ruhlin, the Debtors' former Treasurer, testified that the Debtors understood that the Former Bilateral Facilities Collateral "would be covered by the blanket lien as long as they ... were owned [by the Debtors] and not pledged elsewhere to another bilateral facility," and that the Debtors' "understanding" was that "once an asset was released from a funding facility, depending on the asset, it would become part of the blanket lien." (Ruhlin Dep. 89:14–2, 93:8–14, 165:5–9.)

Ms. Farley, in her capacity as the Debtors' corporate representative, admitted at her deposition that if a loan was initially excluded from the collateral pool because it was pledged to a Bilateral Facility as of the Issue Date, the loan would be transferred into the pool of Blanket Lien Collateral if and when that Bilateral Facility subsequently terminated. (Farley Dep. 105:17–106:21.) At trial, Ms. Farley testified that, with respect to assets that were Excluded Assets as of June 2008 (because they were pledged under a Bilateral Facility), those assets would become part of the revolver and JSN Collateral pools if they fell within the scope of the security grant when the Bilateral Facility terminated. (Oct. 16 Tr. 186:23–187:9.) Ms. Farley further testified that, in negotiating the terms of the AFI revolver, Ally sought to secure the revolver with as much collateral as possible. (Farley Dep. 45:21–46:4; Farley Direct ¶ 13.)

Additionally, in December 2008, the Debtors' outside counsel sent an email explaining that "if at any point while owned by GMAC [ ] the assets are removed from a Bilateral Facility, the [AFI] Revolver and [JSN] Indenture liens may cover these assets and they will constitute Collateral (if and to the extent Sections 9–406/8 of the U.C.C. are applicable)." (DX ES at 1.)

Given the extrinsic evidence presented at trial about the parties' intent "whether an Excluded Asset becomes part of the Secured Parties' collateral pursuant to the All–Asset Granting Clause once it ceases to constitute an Excluded Asset," the Court is satisfied that the Former Bilateral Facilities Collateral is properly treated as JSN Collateral at the Petition Date.

III. *CONCLUSIONS OF LAW*

A. The JSNs Are Entitled to Recover All Original Issue Discount.

[3] The Plaintiffs ask the Court to disallow a portion of the JSNs' claim to the extent the claim seeks recovery of unamortized OID. OID is a form of "deferred interest" created when a bond is issued for less than the face value the borrower contracts to pay at maturity. (Finnerty Direct ¶ 10.) Unlike the more common periodic cash interest "coupon" payments made to noteholders, OID interest accretes over the life of the note but is payable only at maturity. (*Id.*) OID is amortized for tax and accounting purposes over the life of the bond. The Exchange Offer, which was a fair value exchange (*see supra* at ***586** II.F), created $1.549 billion of OID, which amortized over the life of the Junior Secured Notes. (*Id.* at ¶ 11.) As of the Petition Date, unamortized OID on the remaining outstanding Junior Secured Notes was $386 million.[27] (*Id.*)

27 The parties dispute whether the amount of OID at the Petition Date is $386 million (according to the Plaintiffs) or $377 million (according to the Defendants). Since the Court concludes that the amount of the JSNs' claim should not be reduced by OID, the Court need not resolve this dispute.

The JSNs contend that their claim should be allowed in full and should not be reduced by any OID. For the following reasons, the Court agrees that the JSNs' claim should not be reduced by the amount of unamortized OID.

1. In re Chateaugay *Controls and Supports Allowing the JSNs' Claim in Full.*

Bankruptcy Code Section 502(b)(2) provides that a creditor's claim should be allowed in full, "except to the extent that ... such claim is for unmatured interest." 11 U.S.C. § 502(b)(2). The Second Circuit ruled in *Chateaugay* that unamortized OID is "unmatured interest" within the meaning of section 502(b)(2). 961 F.2d at 380. Nevertheless, the Second Circuit found that debt-

for-debt "face value" exchanges offered as part of a consensual workout do not generate OID that is disallowable as unmatured interest for purposes of section 502(b)(2). *Id*. at 383.

The Second Circuit explained that "application ... of OID to exchange offers ... does not make sense if one takes into account the strong bankruptcy policy in favor of the speedy, inexpensive, negotiated resolution of disputes, that is an out-of-court or common law composition." *Id*. at 382. The Second Circuit explained further:

> If unamortized OID is unallowable in bankruptcy, and if exchanging debt increases the amount of OID, then creditors will be disinclined to cooperate in a consensual workout that might otherwise have rescued a borrower from the precipice of bankruptcy. We must consider the ramifications of a rule that places a creditor in the position of choosing whether to cooperate with a struggling debtor, when such cooperation might make the creditor's claims in the event of bankruptcy smaller than they would have been had the creditor refused to cooperate. The bankruptcy court's ruling [excluding OID recovery] places creditors in just such a position, and unreversed would likely result in fewer out-of-court debt exchanges and more Chapter 11 filings.

Id.

Applying that reasoning, the Second Circuit held "that a face value exchange of debt obligations in a consensual workout does not, for purposes of section 502(b)(2), generate new OID." *Id*. Rather than "chang[ing] the character of the underlying debt," a face value exchange "reaffirms and modifies" the debt. *Id*. But the court specifically left open whether the same rules should apply to a fair value exchange such as the one in this case. The court stated:

> [Disallowing OID recovery] might make sense in the context of a fair market value exchange, where the corporation's overall debt obligations are reduced. In a face value exchange such as LTV's, however, it is unsupportable.

Id.

Here, in ruling on the motions to dismiss, the Court concluded that it would benefit from a fuller evidentiary record before resolving whether as a matter of law the Exchange generated disallowable ***587** OID. *Residential Capital,* 495 B.R. at 266. Now having the benefit of a full record and argument, the Court concludes that despite the differences between face value and fair value debt-exchanges, the same rule on disallowance of OID should apply in both circumstances. Since *Chateaugay* is the law of the Circuit, and holds that unamortized OID should not be disallowed in the case of a face value exchange, the Court concludes that the unamortized OID generated by the fair value exchange here should not be disallowed from the JSNs' claim.

2. The Legislative History of Section 502(b)(2)

Section 502(b)(2) was enacted in 1978. The legislative history states that disallowed interest shall include "any portion of prepaid interest that represents an original discounting of the claim [but] would not have been earned on the date of bankruptcy," and gives as an example: "postpetition interest that is not yet due and payable, and any portion of prepaid interest that represents an original discounting of the claim, yet that would not have been earned on the date of the bankruptcy." H.R.Rep. No. 95–595, 95th Cong., 1st Sess. 352–54 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6308.

At the time that Congress passed section 502(b)(2), debt-for-debt exchanges did not create OID for tax purposes. (*See* Bankruptcy Reform Act of 1978, Pub.L. No. 95–598, § 101, 92 Stat. 2549 (1978), "The Internal Revenue Code Tax Code") was first amended in 1990 to provide that both distressed face value exchanges and distressed fair value exchanges create taxable OID. See Omnibus Budget Reconciliation Act of 1990, Pub.L. No. 101–508, § 11325, 104 Stat. 1388–466 (1990). Since that time, both the Second and Fifth Circuits have found that face value exchanges do not create disallowable unmatured

interest, notwithstanding that they may create OID under the Tax Code. *SeeChateaugay*, 961 F.2d at 383 ("The tax treatment of a transaction ... need not determine the bankruptcy treatment.... The tax treatment of debt-for-debt exchanges derives from the tax laws' focus on realization events, and suggests that an exchange offer may represent a sensible time to tax the parties. The same reasoning simply does not apply in the bankruptcy context."); *Texas Commerce Bank, N.A. v. Licht* (*In re Pengo Indus., Inc.*), 962 F.2d 543, 550 (5th Cir.1992) ("As bluntly stated by the Second Circuit, the reasoning underlying the tax treatment of debt-for-debt exchanges simply does not apply in the bankruptcy context.") (internal quotation marks omitted).

The parties do not dispute that disallowable OID is created for bankruptcy purposes when a company issues new debt in an original cash issuance for less than its face value. (Finnerty Direct ¶ 76; Oct. 21 Tr. 155:7–15.) Dr. Finnerty testified that "as an economic matter the bond exchange generated OID," but Dr. Finnerty never defines "economic matter" beyond references to taxable OID. (*Id.* at ¶ 10.) Under *Chateaugay,* however, creation of OID for tax purposes is irrelevant in the context of face value exchanges. Because the Court finds no basis for distinguishing OID generated by fair value exchanges from OID generated by face value exchanges, *Chateaugay* controls. Even though the Exchange may have generated OID under the Tax Code, that does not dicatate that it created disallowable unmatured interest.

3. There is No Reason to Distinguish OID Generated by Fair Value Exchanges from OID Generated by Face Value Exchanges under the Second Circuit's Reasoning in Chateaugay.

As the Second Circuit observed in *Chateaugay,* an exchange offer made by a ***588** financially impaired company "can be either a 'fair market value exchange' or a 'face value exchange.' " 961 F.2d at 381 (citations omitted).[28] Because the Second Circuit in *Chateaugay* was presented with a face value exchange, the court did not address whether its decision would extend to a fair value exchange. Instead, the Court explicitly limited its holding to face value exchanges, noting that it "might make sense" to disallow OID in a fair market value exchange. *Id.* The Court concludes, having the benefit of a full record and argument, that there is no meaningful basis upon which to distinguish between the two types of exchanges.

28 *See supra* note 24 for the differences between fair market value and face value exchanges.

The Plaintiffs' expert Dr. Finnerty admitted at trial that distinguishing between face value and fair value exchanges is "somewhat arbitrary." (Oct. 21 Tr. 67:10–13.) In fact, Dr. Finnerty acknowledged that nearly all of the features that companies consider in connection with a debt-for-debt exchange can be used in both face value and fair value exchanges: (1) granting of security in the issuer's collateral; (2) interest rate; (3) maturity date; (4) payment priorities; (5) affiliate guarantees; (6) other lending covenants; (7) redemption features; (8) adding or removing a sinking fund or conversion feature; and (9) offering stock with the new debt. (*Id.* at 67:17–69:9.) Other than changing the face value of the bond (which is not possible in face value exchanges), an issuer "could adjust every other factor" available to it. (*Id.* at 69:4–9.) For example, an issuer could provide the exchanging noteholders with security. Both experts testified that there would be no disallowable OID if the Junior Secured Notes were issued at $1,000 face value, even though the new notes were secured while the Old Notes were unsecured, because that exchange would be expressly governed by *Chateaugay*. (*Id.* at 136:9–20; 214:2–4.) Thus, despite the Plaintiffs' contention that the consideration involved in the Exchange—trading the unsecured notes for secured and structurally senior obligations—justifies breaking from the Second Circuit's decision in *Chateaugay,* the evidence presented at trial indicated that the two types of exchanges are virtually identical, and it would be arbitrary for the Court to distinguish between them.

The Court thus concludes that there is no commercial or business reason, or valid theory of corporate finance, to justify treating claims generated by face value and fair value exchanges differently in bankruptcy. First, the market value of the old debt is likely depressed in both a fair value and face value exchange. Second, OID is created for tax purposes in both fair value and face value exchanges. Third, there are concessions and incentives in both fair value and face value exchanges. In addition, both fair and face value exchanges offer companies the opportunity to restructure out-of-court, avoiding the time and costs—both direct and indirect—of a bankruptcy proceeding.

The Plaintiffs argue that the "plain language" of the statute must be enforced unless it leads to an absurd result. They contend that applying the language of section 502(b) to disallow OID will not lead to absurd results because even if OID is disallowed, the JSNs' recovery exceeds the recovery of the still-outstanding Original Noteholders. But the term "unmatured interest" in section 502(b)(2) is not defined, making application of the plain language rule debatable. And whatever rules are adopted by courts should provide predictability ***589** to parties in planning transactions. The outcome—whether a transaction results in disallowed OID for bankruptcy purposes—should not hinge on whether, with the benefit of hindsight, noteholders that exchanged their notes did better than those that did not exchange. Determining whether the transaction created disallowable OID should not depend on if the noteholders or the debtors got a "good deal" in bankruptcy. That rule would create confusion in the market and would likely complicate a financially distressed company's attempts to avoid bankruptcy with the cooperation of its creditors. The reasoning of *Chateaugay* supports this conclusion. 961 F.2d at 383.

For the foregoing reasons, the Court concludes that the JSNs' claim should not be reduced by the amount of unamortized OID.

B. The JSNs Are Not Entitled to an Adequate Protection Claim.

1. Generally

The Bankruptcy Code requires a debtor to provide a secured lender with adequate protection against a diminution in value of the secured lender's collateral resulting from: (1) the imposition of the automatic stay under section 362; (2) the use, sale, or lease of the property under section 363; and (3) the granting of a lien under section 364. 11 U.S.C. § 361(1). The Bankruptcy Code does not articulate what constitutes "adequate protection" for purposes of the statute, but section 361 articulates three separate examples of what may constitute adequate protection: (1) periodic cash payments; (2) offering a replacement lien "to the extent that such stay, use, sale, lease, or grant results in a decrease in the value of such entity's interest in such property"; and (3) other relief that will assure the creditor that its position will not be adversely affected by the stay. *Id*.; *see also* 3 COLLIER ON BANKRUPTCY ¶¶ 3 62.07[3][b]–[d] (16th ed. 2011).

A secured creditor is entitled to adequate protection of its interest in the value of its collateral and can obtain adequate protection either after a contested cash collateral hearing, or, as is more often the case, by a consensual cash collateral order. At the commencement of this case, the parties negotiated, and the Court signed, a Cash Collateral Order that, among other things, established the JSNs' right to adequate protection for the use of their collateral and the means by which such adequate protection would be provided. Pursuant to paragraph 16 of the Cash Collateral Order, the JSNs are entitled to

> [A]dequate protection of their interests in Prepetition Collateral, including Cash Collateral, in an amount equal to the aggregate diminution in value of the Prepetition Collateral to the extent of their interests therein, including any such diminution resulting from the sale, lease or use by the Debtors (or other decline in value) of any Prepetition Collateral, including Cash Collateral, the priming of the AFI Lenders' liens on the AFI LOC Collateral by the Carve Out and AFI DIP Loan, and the automatic stay pursuant to section 362 of the Bankruptcy Code[.]

(PX 76 at 24.) As adequate protection, the JSNs were granted adequate protection liens on all of the collateral securing the AFI Revolver, the AFI LOC, and all of the equity interests of the Barclays DIP Borrowers, and, to the extent that such liens were insufficient to provide adequate protection, the right to assert a claim under section 507(b) of the Bankruptcy Code. (*Id*. at 29.) The JSNs now contend they are entitled to recover an adequate protection claim of $515 million based on alleged diminution in value of their prepetition collateral ***590** used during the case under a series of consensual cash collateral orders. The Plaintiffs disagree, asserting that the JSN Collateral has not declined in value since the Petition Date and that the JSNs therefore cannot assert an adequate protection claim.

The parties agree that the amount of any adequate protection claim is to be measured by the difference in value of the collateral on the Petition Date and the Effective Date. [29] The parties also largely agree about the Effective Date value of the JSN Collateral,

subject to adjustments discussed elsewhere in this Opinion. Thus, much of the testimony offered at trial was aimed at establishing the Petition Date value of the JSNs' collateral.

29 Here, the cash collateral motion was filed as a first day motion, so there is no issue of whether a later date should apply for purposes of an adequate protection claim. *See* 4 COLLIER ON BANKRUPTCY ¶ 506.03[7][a][iv] ("In general, courts typically hold that, for purposes of adequate protection, the value of the collateral is to be determined either as of the petition date or as of the date on which the request for adequate protection was first made.").

2. The JSNs Bear the Burden of Showing Diminution in Value.

[4] **[5]** The burden of proving valuation falls on different parties at different times. In establishing its claim, a secured creditor generally bears the burden under section 506(a) of proving the amount and extent of its lien. *In re Sneijder,* 407 B.R. 46, 55 (Bankr.S.D.N.Y. 2009); *see also In re Heritage Highgate, Inc.,* 679 F.3d 132, 140 (3d Cir.2012) (holding that "the ultimate burden of persuasion is upon the creditor to demonstrate by a preponderance of the evidence both the extent of its lien and the value of the collateral securing its claim") (quoting *In re Robertson,* 135 B.R. 350, 352 (Bankr.E.D.Ark.1992)). Once the amount and extent of the secured claim has been set, the burden shifts to a debtor seeking to use, sell, lease, or otherwise encumber the lender's collateral under sections 363 or 364 of the Code to prove that the secured creditor's interest will be adequately protected. *See Wilmington Trust Co. v. AMR Corp. (In re AMR Corp.),* 490 B.R. 470, 477–78 (S.D.N.Y.2013) (holding that the creditor seeking adequate protection "need only establish the validity, [priority, or extent] of its interest in the collateral, while the Debtor bears the initial burden of proof as to the issue of adequate protection") (internal quotation marks and citation omitted); *see also Resolution Trust Corp. v. Swedeland Dev. Grp., Inc. (In re Swedeland Dev. Grp., Inc.),* 16 F.3d 552, 564 (3d Cir.1994) (holding, in the context of granting a priming lien under section 364(d)(1), that the "debtor has the burden to establish that the holder of the lien to be subordinated has adequate protection") (citation omitted). In contrast, a secured creditor seeking to lift the automatic stay under section 362(d)(1) "for cause, including lack of adequate protection," bears the burden of showing that the debtor lacks equity in the property. 11 U.S.C. §§ 362(d)(1), 362(g)(1); *see also In re Elmira Litho, Inc.,* 174 B.R. 892, 900–03 (Bankr.S.D.N.Y.1994). But in all cases, the creditor bears the burden in the first instance of establishing the amount and extent of its lien under section 506(a).

The JSNs recognize that they must establish their section 507(b) adequate protection claim within the rubric of section 506(a). Further, they concede that the burden of proving the extent of a claim is typically born by the creditor seeking to establish the claim. Nonetheless, the JSNs argue that because their claim seeks adequate protection, the Debtors should have the burden of proving that the JSNs' ***591** interests were adequately protected. The Court disagrees.

[6] The parties established at the outset of this case that the JSNs' interest in their collateral was adequately protected, when they negotiated, and the Court signed, the Cash Collateral Order.[30] As the Court explained in its ruling on the motions to dismiss:

> If the value of the JSNs' collateral actually diminishes, then the JSNs may assert an adequate protection claim.... The Defendants caution against establishing new rules on adequate protection and valuation, but the Court's decision is premised on the terms of the Cash Collateral Order, which the JSNs helped negotiate. That Order provided the JSNs with bargained-for adequate protection.

Residential Capital, 497 B.R. at 420. The bargained-for adequate protection included several liens and the right to assert a claim under section 507(b) for any diminution in value not otherwise protected. (PX 76 at 29.) That the JSNs now seek to assert this adequate protection claim based on diminution in value does not shift the initial burden of proving the extent and validity of the claim under section 506(a) to the Debtors. Rather, this burden remains squarely with the secured creditor—the JSNs.[31] *See, e.g., Qmect, Inc. v. Burlingame Capital Partners II, L.P.*, 373 B.R. 682, 690 (N.D.Cal.2007) (affirming bankruptcy court's requirement that secured lenders prove diminution in value of collateral prior to foreclosing on replacement liens, because "the purpose of adequate protection is to protect lenders from diminution in the value of their collateral").

30 There is no question here that the JSNs received adequate protection by a very substantial postpetition lien on collateral (far beyond the property covered by the JSNs' liens on the petition date). Had there been a contested cash collateral hearing the Debtors would have had the burden of establishing adequate protection; that was unnecessary because of the agreement of the parties. The issue now is different: Are the JSNs entitled to recover a claim based on a diminution in the aggregate value of their collateral at the petition date? As explained in the text, on that issue the JSNs have the burden of proof.

31 None of the cases cited by the Defendants support the proposition that in a post-hoc analysis of the sufficiency of adequate protection, the debtor continues to bear the burden of proving adequate protection. Rather, they all involve the well-established rule that, before a debtor may use, sell, lease, or otherwise encumber the lender's collateral, the debtor must show that the creditor's interest will be adequately protected. *See Swedeland,* 16 F.3d at 564 (discussing whether adequate protection existed sufficient to grant a priming lien); *Wilmington Trust Co. v. AMR Corp. (In re AMR Corp.),* 490 B.R. 470, 477–78 (S.D.N.Y.2013) (discussing whether a secured lender was entitled to adequate protection during the pendency of the case); *In re Erewhon, Inc.,* 21 B.R. 79, 84 (Bankr.D.Mass.1982) (stating that a secured creditor worried about diminution in value need only object to use of collateral "since the burden of proving adequate protection is substantially that of the Debtor"); *Hamilton Bank v. Diaconx Corp. (In re Diaconx Corp.),* 69 B.R. 333, 338 (Bankr.E.D.Pa.1987) (denying use of cash collateral because debtor failed to carry burden of showing that secured lender's interest "would be adequately protected"). As the Court already explained, the parties already agreed that the JSNs' interest in their collateral would be adequately protected when they signed the Cash Collateral Order.

3. Fair Market Value in the Hands of the Debtors is the Proper Petition Date Valuation Methodology.

The Plaintiffs argue that for adequate protection purposes, the collateral should be valued at the Petition Date based on the foreclosure ***592** value of the collateral in the hands of the secured creditor. The Defendants argue that the collateral should be valued based on the fair market value of the collateral in the hands of the Debtors. The Court agrees with the Defendants that fair market value rather than foreclosure value applies, but as explained below, this holding provides little benefit to the Defendants because the Defendants' fair market valuation evidence introduced by their expert witnesses is unreliable, vastly overstates the value of the collateral on the Petition Date, and is rejected by the Court as a basis to establish an adequate protection claim.

[7] **[8]** To establish their entitlement to an adequate protection claim, the JSNs must show that the aggregate value of their collateral diminished from the Petition Date to the Effective Date. The JSNs will only be entitled to adequate protection, if at all, to the extent of the value of their interest in the collateral as of the Petition Date. 11 U.S.C. § 361. The Supreme Court has explained that the phrase "value of such entity's interest" in section 361 means the same as the phrase "value of such creditor's interest" in section 506(a): the value of the collateral. *United Sav. Ass'n of Texas v. Timbers of Inwood Forest Assocs., Ltd.,* 484 U.S. 365, 372, 108 S.Ct. 626, 98 L.Ed.2d 740 (1988). Thus, the question becomes how to value the JSN Collateral as of the Petition Date. To answer this question, the Court looks to valuation principles under section 506(a). *See In re Winthrop Old Farm Nurseries, Inc.,* 50 F.3d 72, 74 (1st Cir.1995) (stating that "a valuation for § 361 [i.e. adequate protection] purposes necessarily looks to § 506(a) for a determination of the amount of a secured claim").

Section 506(a) provides:

> An allowed claim of a creditor secured by a lien on property in which the estate has an interest ... is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property ... and is an unsecured claim to the extent that the value of such creditor's interest ... is less than the amount of such allowed claim. *Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property....*"

11 U.S.C. § 506(a)(1) (emphasis added).

In *Associates Commercial Corp. v. Rash,* the Supreme Court interpreted section 506(a) in the context of a chapter 13 plan, where the chapter 13 debtor sought to cram down a plan over the objection of a secured creditor, keeping the secured lender's collateral. 520 U.S. 953, 955, 117 S.Ct. 1879, 138 L.Ed.2d 148 (1997). In calculating the value of the lender's secured claim,

the Court looked at the first sentence of section 506(a) and observed that the phrase "value of such creditor's interest" did not explain *how* to value the interest. *Id*. at 960–61, 117 S.Ct. 1879. Therefore, the Court looked to the second sentence of 506(a) and held that "the 'proposed disposition or use' of the collateral is of paramount importance to the valuation question." *Id*. at 962, 117 S.Ct. 1879. Based on the proposed disposition of the property in that case, the Court held that foreclosure value could not be the proper methodology for valuing the secured creditor's claim. *Id*. at 963, 117 S.Ct. 1879. Rather, the Court applied replacement value; the amount a willing buyer would have paid a willing seller for the collateral. *Id*.

Although this case involves the consensual use of collateral in the context of a sale under chapter 11, the reasoning of *Rash* is equally applicable here. *See In re Motors Liquidation Co*., 482 B.R. 485, 492 (Bankr.S.D.N.Y.2012) (holding that "*Rash* 's underlying thought process is still instructive" in calculating value in a 363 sale and further noting that "[p]ost–*Rash* case law suggests that *Rash* can be applied to the provisions of all three reorganization ***593** chapters—11, 12, and 13—because these chapters all treat secured claims similarly"); *see also Heritage Highgate,* 679 F.3d at 141 (applying *Rash* in chapter 11 to value secured claim under 506(a)).

The Defendants cite only one case that deals with the exact scenario of this case—diminution of collateral in the context of a consensual use of cash collateral that funded a going concern sale—in which the district court affirmed application of the *Rash* reasoning in the adequate protection context. *See Salyer v. SK Foods, L.P. (In re SK Foods, L.P.),* 487 B.R. 257, 262 n. 11 (E.D.Cal.2013). In *SK Foods,* secured creditors and the chapter 11 trustee had negotiated a settlement on the amount of the creditors' adequate protection claim, conducting their valuation based on the proposed disposition of the collateral on the petition date—a going concern sale. *Id*. at 259–60. The bankruptcy court approved the settlement. *Id*. The appellants objected, asserting that the proper valuation could only be liquidation value, setting the value of the secured creditors' adequate protection claim at "0." *Id*. at 260. The district court rejected that argument, holding that "the Bankruptcy Court properly relied upon the 'liquidation' value for those assets which were to be liquidated, and as required by *Rash,* properly relied upon the 'going-concern' value for those assets which were to be sold as part of the business as a going concern." *Id*. at 263.

None of the other cases that the Defendants cite involve the calculation of an adequate protection claim based on diminution in value due to consensual use of collateral. Instead, the cases cited by the Defendants involve valuations performed for forward-looking determinations of whether secured creditors' interests would be adequately protected.[32] Nonetheless, ***594** the Court views the current valuation exercise as similar in nature. That is, the Court is being asked to apply a Petition Date valuation of the JSN Collateral to determine whether the JSNs' interests as of that date were adequately protected. In doing so, the Court agrees with the holdings of *SK Foods* and the other cases cited by the Defendants that the proper valuation methodology must account for the proposed disposition of the collateral.

32 *See In re Walck,* No. 11–37706(MER), 2012 WL 2918492, at *2 (Bankr.D.Colo. Jul. 17, 2012) (in the context of a motion for relief from stay, construing section 506(a) in light of *Rash,* finding that secured creditor was adequately protected based on the fair market value of collateral projected to be earned by sale); *Bank R.I. v. Pawtuxet Valley Prescription & Surgical Ctr.,* 386 B.R. 1, 4 (D.R.I.2008) (holding that going concern/fair market value could be used where secured lender objected to finding that it was adequately protected); *In re Eskim LLC,* No. 08–509, 2008 WL 4093574, at *2–4 (Bankr.N.D.W.Va. Aug. 28, 2008) (in the context of motion for relief from stay, temporarily permitting debtor to use collateral to bridge to a going concern sale, and finding secured creditor might be adequately protected given that "the court's accepted valuation of the property depends on its being sold at a going concern value—not one of foreclosure"); *In re Pelham Enters., Inc.,* 376 B.R. 684, 690–93 (Bankr.N.D.Ill.2007) (in the context of a motion for relief from stay, construing section 506(a) in light of *Rash* and rejecting estimated liquidation value of collateral in the hands of creditor given undisputed evidence that the collateral was actually being used as part of debtor's going concern); *In re Deep River Warehouse, Inc.,* No. 04–52749, 2005 WL 1287987, at *7–8 (Bankr.M.D.N.C. Mar. 14, 2005) (construing section 506(a) in the context of a motion for relief from stay, and finding secured creditor to be adequately protected based on real property's going concern value in light of debtor's proposal to retain property as a going concern); *In re Davis,* 215 B.R. 824, 825–26 (Bankr.N.D.Tex.1997) (construing section 506(a) in the adequate protection context in light of *Rash,* and holding that secured creditor in chapter 13 case was adequately protected based on the car's fair market value as of the petition date when debtor intended to retain and use the collateral); *In re Savannah Gardens–Oaktree,* 146 B.R. 306, 308–10 (Bankr.S.D.Ga.1992) (adopting going concern valuation where collateral was to be retained and used under chapter 11 plan, in order to determine amount of secured claim under 506(a) and evaluate whether

claim would be adequately protected by value of collateral); *In re Kids Stop of Am., Inc.*, 64 B.R. 397, 401–02 (Bankr.M.D.Fla.1986) (construing section 506(a) in the adequate protection context, and concluding that secured creditor was entitled to continue receiving adequate protection payments because the collateral as of petition date was worth the amount actually realized from asset sales during the case); *Bank Hapoalim B.M. v. E.L.I., Ltd.*, 42 B.R. 376, 379 (N.D.Ill.1984) (in context of motion for relief from stay, affirming bankruptcy court's utilization of an executed sale contract for valuation of sold collateral under section 506(a) to determine whether the secured creditor was adequately protected); *First Trust Union Bank v. Automatic Voting Mach. Corp. (In re Automatic Voting Machine Corp.),* 26 B.R. 970, 972 (Bankr.W.D.N.Y.1983) (for purposes of determining whether secured creditor was adequately protected on motion for relief from stay, rejecting evidence of liquidation value and holding that going concern methodology is appropriate when collateral is to be retained and used).

The Debtors would like this Court to apply a foreclosure standard based on the JSNs' interest in the collateral as of the Petition Date, which, the Debtors contend, was simply to be able to foreclose on the property. Thus, because "the purpose of providing adequate protection is to insure that the secured creditor receives the value for which the creditor bargained for prior to the debtor's bankruptcy," *In re WorldCom, Inc.*, 304 B.R. 611, 618–19 (Bankr.S.D.N.Y.2004), the JSNs should be entitled to foreclosure value of the collateral as of the Petition Date—and no more. In support, the Debtors cite to a line of cases holding that under a section 506(a) analysis, a secured lender's interest is limited to the right to foreclose upon the property. [33]

33 *See In re Scotia Dev., LLC,* No. 07–20027, slip op. at 23–24 (Bankr.S.D.Tex. July 7, 2008) ("With non-cash property, the interest that secured creditor has a right to is the right to foreclose. Therefore, the case law suggests that the appropriate value to protect is the foreclosure value of the property and not the fair market value of the property."), *aff'd in part, In re SCOPAC,* 624 F.3d 274, 285–86 (5th Cir.2010); *In re Ralar Distribs., Inc.*, 166 B.R. 3, 7 (Bankr.D.Mass.1994) ("The value relevant for adequate protection purposes, however, is not book value. It is liquidation value realizable by the creditor."), *aff'd,* 182 B.R. 81 (D.Mass.1995), *aff'd,* 69 F.3d 1200 (1st Cir.1995); *Sharon Steel Corp. v. Citibank, N.A. (In re Sharon Steel Corp.),* 159 B.R. 165, 169 (Bankr.W.D.Pa.1993) (using liquidation value for adequate protection purposes); *United States v. Case (In re Case),* 115 B.R. 666, 670 (9th Cir. BAP 1990) ("If we were attempting to value FmHA's interest in the property for adequate protection purposes, the possibility of forced liquidation would be assumed and a deduction for selling costs would be logical."); *La Jolla Mortg. Fund v. Rancho El Cajon Assocs.*, 18 B.R. 283, 289 (Bankr.S.D.Cal.1982) ("In this regard, we must evaluate the collateral, being the adequate protection, in the hands of the claim holder. It is the creditors' expected costs to liquidate the property that is relevant, not those of the debtor.").

The Court disagrees, and in light of the Supreme Court's rulings in *Rash* and *Timbers,* the Court finds the cases cited by the Plaintiffs unpersuasive. *See Winthrop,* 50 F.3d at 75–76 (disapproving of cases that "render[ ] the second sentence of § 506(a) virtually meaningless" and holding that "a court remains faithful to the dictates of § 506(a) by valuing the creditor's interest in the collateral in light of the proposed post-bankruptcy reality: no foreclosure sale and economic benefit for the debtor derived from the collateral equal to or greater than its fair market value"). In this case, the parties were not contemplating on the Petition Date that the creditors might conduct a foreclosure sale. The Debtors never had any intention of turning over the JSN Collateral to the collateral ***595** agent. (Oct. 15 Tr. 164:21–165:2, 249:6–16.) Nor did the JSNs foreclose or attempt to foreclose on the assets. Rather, the JSNs entered into a cash collateral stipulation to allow the sale of assets as a going concern. (DX AIJ at 5.) A going concern valuation is consistent with the Debtors' stated purpose in this case as of the Petition Date, which, among other things was "preserv[ing] the Debtors' servicing business on a going concern basis for sale." (PX 137 at 7.) The testimony at trial confirmed that the parties always intended to market and sell the properties as a going concern. This is also evident by looking at the stalking horse APAs that were in place on the Petition Date. [34] Thus, in determining the value of the JSN Collateral on the Petition Date, the Court must apply that value based on the proposed disposition of the collateral—fair market value in the hands of the Debtors.

34 The Nationstar APA states clearly that the purchased assets are "Related to the Business." (PX 33 at 38.) Related to the Business is defined in the Nationstar APA as "required for, held for, or used in the conduct of the Business." (*Id.* at 30.) The Business described in the Nationstar APA is, broadly, the Debtors' servicing and origination business. (*Id.* at 13, definition of "Business.") In addition, the Nationstar APA specifically enumerates goodwill as a purchased asset. (*Id.* at 40.) Finally, in a provision requiring the Debtors to effect "Separation Services," the Nationstar APA states that a stand-alone business was part of the bargain, and that "Sellers acknowledge and agree that Separation Services are intended to permit Sellers to deliver at Closing to the Purchaser the Business and Purchased Assets as a stand-alone business...." (*Id.* at 84.)

4. The JSNs Did Not Calculate the Fair Market Value of the Impaired Collateral in the Hands of an Insolvent Company and Have Therefore Failed to Carry Their Burden of Proving a Diminution in Value.

[9] While the Court agrees with the Defendants that the correct methodology for Petition Date valuation is fair market value in the hands of the Debtors, the Court finds that the Defendants have not provided a credible valuation of their collateral as of that date. Therefore, the Defendants have failed to carry their burden of proving a diminution in the value of their collateral, and their adequate protection claim fails. [35]

35 The Court notes that it was equally unimpressed with the testimony presented by Mr. Puntus on behalf of the Plaintiffs. But since the burden of proof lies with the Defendants, the shortcomings of Mr. Puntus's methodology do not alter the result.

As detailed above, the JSNs offered valuation testimony from four experts affiliated with Houlihan. The Houlihan opinions of the fair market value of each asset comprising the JSN Collateral was informed, where applicable, by the prices obtained in the auction process, adjusted for cash flows and loan balances back to the Petition Date. (Siegert Direct ¶ 18.) In addition, Houlihan performed a "bottoms-up" fair market valuation as of the Petition Date. Mr. Siegert offered a single "Global Summary" of the Houlihan opinions suggesting the net fair market value of the JSN Collateral on the Petition Date totaled $2.79 billion—nearly $1 billion more than the stipulated Effective Date value of the same collateral. (Siegert Direct ¶¶ 4, 25; Oct. 23 Tr. 134:1–14, 141:14–142:6; DX ABF at 10.) While the Court recognizes that the Houlihan experts used accepted valuation methodologies, the assumptions and inputs they used were seriously flawed. As a result, Houlihan's conclusions regarding value are not credible.

First, the Houlihan experts' valuation assumes that the JSN Collateral could have been sold on the Petition Date by the Debtors. (Oct. 22 Tr. 139:18–142:4; Oct. ***596** 23 Tr. 147:23–149:3, 149:18–22.) This assumption ignores reality. For example, Mr. Levine's opinion assumes a sale with appropriate representations, warranties, and market indemnifications from the seller; he valued the assets assuming that they could be sold free and clear of certain obstacles to sale. (Oct. 22 Tr. 62:17–21.) But at trial, Mr. Levine conceded that a sale of MSRs would have required the consent of the RMBS Trustees and of the GSEs. (*Id.* at 64:8–65:9.) Mr. Levine did not take into account the costs associated with obtaining the requisite consents, and simply assumed that the transaction would have closed upon the receipt of all required consents. (*Id.* at 63:15–25.) Those costs were considerable, including hundreds of millions of dollars in payments to GSEs to cure alleged liabilities to those entities and obtain their consent to the sale. (*Id.* at 67:1–22; PX 388 ¶ 1.) There was no assurance that the consents could be obtained. In addition, the Debtors agreed to settle billions of dollars of potential RMBS liability to obtain consent of the RMBS Trustees and be able sell the assets free and clear. (Marano Direct ¶ 43.) Mr. Levine's valuation did not account for the potential reduction in funds available to the lender or seller in a sale of those assets nor did his valuation take into account the time and difficulty in obtaining those consents. (*Id.* at 72:7–73:10, 69:10–69:20.)

Second, even assuming that the Debtors could have sold their assets on the Petition Date—an assumption the Court views with considerable skepticism—the Houlihan valuation suffers from another, fatal flaw. When valuing the assets, the Defendants' experts did not look to sales conducted by other distressed entities on the brink of insolvency. The experts instead only considered a solvent company, able to capture fair value for its assets. Thus, even if the Court accepts that the assets were saleable on the Petition Date—before all of the of work conducted during the bankruptcy necessary to make them saleable—the Houlihan experts' valuation cannot be relied upon because it provides a fair market value of the assets in the hands of a solvent company. Most of the assets could not simply be turned over to a buyer who could instantly reap full value as if the assets were commodity products. MSRs require that accurate mortgage security records are provided. The Houlihan valuation ignores the reality of the period leading up to this bankruptcy: ResCap was an insolvent company, over-burdened with debt, owning assets that had to be "fixed" before they could be sold, and facing a real possibility of being shut down. As Mr. Levine testified, the GSEs had the right to terminate ResCap's servicing rights and transfer the rights to another party upon any breach of their servicing agreement. (*Id.* at 96:22–97:7.) Therefore, the Court finds the Houlihan analysis flawed in its premise, and unreliable.

The Court is mindful that the Debtors have spent money that belonged to the JSNs. But while the JSNs' cash collateral has been consumed during the case consistent with the Cash Collateral Forecasts, this does not mean that the JSNs have suffered a diminution in the aggregate value of their collateral.[36] As already held by the Court, the JSNs are not entitled to an adequate protection claim on a dollar-for- ***597** dollar basis for cash collateral used during the case. *Residential Capital*, 497 B.R. at 420. Where cash collateral use is permitted according to an approved budget, and the cash collateral order includes a section 506(c) waiver, the two provisions work in tandem. Unless the remaining value of the cash and non-cash collateral at the effective date falls below the value of the collateral on the petition date, the creditor is not entitled to compensation for the amount of cash collateral spent under the approved budget. But the debtor does not get to charge the secured creditor again for any costs of preserving or enhancing the collateral.

36 As Collier explains:

> However, often a secured party will consent to limited use of cash collateral to preserve the value of his interest in other collateral. Payment of expenses of preserving non-cash collateral, payroll expenses to keep the business operating and other immediate cash needs may be as important to a secured party early in the case as it is to the debtor in possession.

3 COLLIER ON BANKRUPTCY ¶ 363.03[4], at 363–34.

Rather, the Defendants have the burden of showing that there has been a diminution in the aggregate value of JSN Collateral. Case law and the Cash Collateral Order both impose this requirement. The Defendants failed to make this required showing. Simply put, the Court cannot accept that the value of the JSN Collateral on the Effective Date does not exceed the value of their collateral on the Petition Date, even after the expenditure of the JSNs' cash collateral. This result was achieved because the value of the collateral at the Petition Date (even valued in the hands of the Debtors on a going concern basis) was very substantially impaired by reason of existing defaults that prevented Debtors from disposing of most of their collateral at that time. Through the settlements and consents achieved over many months, with great effort and expense, the Debtors successfully closed the sales of most of their assets on very favorable terms. The JSNs and all estate creditors will benefit from this accomplishment.

C. The JSNs Can Establish Whether They Are Oversecured by Aggregating Their Claims against Debtor Entities.

[10] Under section 506(b) of the Bankruptcy Code, a secured creditor is ***598** entitled to postpetition interest, fees, costs and charges to the extent the value of the property securing the creditor's claim is greater than the amount of the creditor's claim. 11 U.S.C. § 506(b). The Debtors contend that under applicable law, the JSNs must be oversecured at a single Debtor entity—without reference to JSN Collateral held by other Debtor entities—to be entitled to postpetition interest. In contrast, the JSNs argue that a determination of their oversecured status must be made based on the aggregate value of their collateral, across Debtor entities. There is a surprising dearth of case law explicitly addressing the issue of valuing the extent of a creditor's security in multi-debtor cases. The statute likewise does not provide much guidance. The Court agrees with the JSNs that they are entitled to aggregate their collateral across debtor entities. Any other reading of the statute would lead to inequitable and illogical results.

Section 506(b) permits a secured creditor to collect postpetition interest to the extent that its "allowed secured claim is secured by property the value of which ... is greater than the amount of such claim." 11 U.S.C. § 506(b). Section 506(a), in turn, establishes the rule governing the calculation of secured claims. That section provides that a creditor's claim is secured "to the extent of the value of such creditor's interest in the estate's interest in [the securing] property." 11 U.S.C. § 506(a)(1).

[11] **[12]** Based on the language of the statute, the Plaintiffs argue that even where a creditor's claim is secured by collateral pledged by other debtors, it is necessary to examine the value of a specific "estate's interest" under section 506(a) to determine whether the secured creditor is entitled to postpetition interest with respect to its claim against that particular debtor under section 506(b).[37] This view seems to follow from the general principle that, absent substantive consolidation, a court will not pool the assets of multiple debtors to satisfy their liabilities. *See Union Sav. Bank v. Augie/Restivo Baking Co. (In re Augie/Restivo Baking Co.),* 860 F.2d 515, 518 (2d Cir.1988). "Because of the dangers in forcing creditors of one debtor to share on a parity with creditors of a less solvent debtor, ... substantive consolidation ... [is] to 'be used sparingly.' " *Id.* (quoting *Chemical Bank New York Trust Co. v. Kheel,* 369 F.2d 845, 847 (2d Cir.1966)) (citation omitted). But aggregating collateral for purposes

of determining whether a secured creditor is oversecured and entitled to postpetition interest and fees does not run afoul of this rule. No debtor in a multi-debtor case will be required to pay a secured creditor more than the value of the secured creditor's collateral. The secured creditor by definition has a superior right to the value of the collateral; junior creditors have no right to share on a parity with the secured creditor.

37 As a matter of statutory construction, the Defendants argue that while section 506 of the Bankruptcy Code—and indeed, the entire Bankruptcy Code—is written for a single debtor, section 102(7) of the Bankruptcy Code (the "Rules of Construction" section) explicitly provides that "the singular includes the plural." 11 U.S.C. § 102(7). Thus, in multi-debtor cases, courts will treat Bankruptcy Code provisions that refer to a single debtor as referring to all debtors. *See, e.g., In re Vagi,* 351 B.R. 881, 885 (Bankr.N.D.Ohio 2006) (holding that, in a case involving co-debtors, under subsection 102(7), the phrase "acquired for the personal use of the debtor" in subsection 1325(a) "may also be read, 'acquired for the personal use of the debtors' "). The Defendants contend therefore that section 506(a)(1) is properly read as follows: "an allowed claim of a creditor secured by lien[s] on property in which the estate[s] have an interest ... is a secured claim to the extent of the value of such creditor's interest in the estate[s'] interest in such property...." (Defendants' Motion to Dismiss, ECF No. 13–01343 Doc. # 21–1 at 9.) The Court is unconvinced by either party's statutory interpretation argument. Indeed, the statute seems silent on the issue at hand.

In support of their interpretation of section 506(a), the Plaintiffs cite to *DeNofa v. Nat'l Loan Investors L.P. (In re DeNofa),* 124 Fed.Appx. 729 (3d Cir.2005). In *DeNofa,* the Third Circuit addressed whether a secured creditor, secured by both debtor and non-debtor assets, was entitled to aggregate its collateral to become oversecured. *Id.* at 730–31. The court held that it was not, stating that "the allowed secured claim of [a secured lender to] examine for purposes of postpetition interest under § 506(b) is limited to the extent of the value of the property of the [debtor's] bankruptcy estate which secures it [under § 506(a)]." *Id.* at 731. But *DeNofa* dealt with debtor and non-debtor entities; it did not address the situation presented here—multiple debtor obligors may own collateral sufficient, in the aggregate, to render a secured creditor oversecured. While the Plaintiffs contend this is a distinction without a difference, the Court disagrees. There is no scenario where a debtor will ever have to pay on a secured claim more than the value of the collateral securing the debt. However, when all of the secured lender's obligors are in bankruptcy, to the extent that the aggregate value of the collateral exceeds the lender's claim, the estates' unencumbered assets are unaffected by the payment of postpetition interest, and there is nothing inequitable about permitting the secured lender to apply its collateral towards postpetition interest once its prepetition claim has been paid in full. Therefore, *DeNofa* 's analysis is not dispositive of the questions presented ***599** here.[38]

38 Another case cited by the Plaintiffs is equally unhelpful because it also deals with non-debtor entities. *SeeOfficial Comm. of Unsecured Creditors of Toy King Distribs., Inc. v. Liberty Sav. Bank (In re Toy King Distribs., Inc.),* 256 B.R. 1, 187 (Bankr.M.D.Fla.2000) ("Although the collateral subject to [creditor's] loan includes the property of the individual guarantors and property of the debtor, only the debtor's property is relevant to the court's determination of the secured status of [creditor's] claim against the debtor under Section 506."). The Defendants also argue out that even if *DeNofa's* interpretation of subsection 506(b) is correct, it would not change the outcome here, because pursuant to section 102(7), "the singular includes the plural," and the term "estate" must be interpreted as including all debtor "estates" holding collateral. Therefore, *DeNofa* could still be read to include all debtor estates in the section 506(b) calculation.

In another ill-fated attempt to shed light on the issue, the Plaintiffs cite to a Second Circuit case holding that the filing of a joint petition by spouses under section 302 of the Bankruptcy Code "does not automatically consolidate their estates," nor does it "allow the property of one spouse to be used to satisfy the debts of the other spouse." *Wornick v. Gaffney,* 544 F.3d 486, 491 (2d Cir.2008). In *Wornick,* the Second Circuit held that "the trustee may not reach assets in a joint filing that he could not have reached had the spouses filed separately." *Id.* The Plaintiffs assert that the same principle should prevail in the context of section 506(a).

But comparison to *Wornick* ignores the important fact that only collateral securing the debt is at stake here; *Wornick* is easily distinguishable and of little utility to the Court. The interests at question in *Wornick* were the cash surrender values of several life insurance policies. *Id.* at 488. The Second Circuit found that under the applicable state insurance law, had the spouses filed separately, neither spouse's creditors could have claimed an interest in the policies' surrender values. *Id.* at 489–91 (finding that "the beneficiary has no legal or equitable interest in the policy that could be made part of the property of the beneficiary's

bankruptcy estate" and that "the trustee would have been powerless to administer the cash surrender value as part of the estate of the owner/insured because [insurance law] provides an express exemption in favor of the beneficiary"). Under those facts, the court held that "[a] joint filing does not vest the trustee with the power to reach a spouse's assets that would have otherwise been insulated...." *Id.* at 491. The facts in front of this Court are completely different. The JSNs do have a right to assert claims against property held at each of the individual Debtors. Thus, the question presented here does not involve property that does not form part of the secured creditor's collateral; only collateral pledged to the secured creditor will be used to pay postpetition interest. Rather, the question is whether property subject to the JSNs' liens, held across multiple debtors, can be aggregated for the purposes of making the JSNs oversecured.

The Defendants cite two cases explicitly rejecting arguments that a secured creditor had to be oversecured at a single debtor in order to be entitled to postpetition interest.[39] *See* ***600** *In re SW Hotel Venture, LLC,* 460 B.R. 4, 26 (Bankr.D.Mass.2011),*aff'd in part and rev'd on other grounds sub nom. Prudential Ins. Co. of Am. v. City of Boston (In re SW Boston Hotel Venture, LLC),* 479 B.R. 210 (1st Cir. BAP 2012); *In re Revolution Dairy, LLC*, Case No. 13–20770 (Bankr.D.Utah Apr. 29, 2013) Hr'g Tr. [Docket No. 206] (the "Rev. Dairy Tr."). In *SW Hotel Venture*, the debtors, like the Plaintiffs here, argued that a secured creditor "cannot aggregate the value of all of the Debtors' assets to establish an entitlement to postpetition interest." 460 B.R. at 22. The court "unequivocally reject[ed]" this argument, ruling instead that "the determination of [a secured creditor's] status as an oversecured (or undersecured) creditor must be made aggregating the collateral of all the Debtors...." *Id.* at 33.[40] In Revolution Dairy, the court reached the same conclusion. There, affiliated debtors argued that the collateral held by each debtor should be considered separately for purposes of determining the secured creditors' entitlement to postpetition interest and fees under section 506(b). In rejecting the debtors' position, the court noted that the debtors' failure to "cite ... case authority in support of their argument" was "not surprising," as "[t]he argument is clearly inconsistent with the code and cannot stand modest scrutiny." *Revolution Dairy*, No. 13–20770, Rev. Dairy Tr. at 12:19–13:3.

39 Other cases cited by the Defendants either involved substantively consolidated debtors or merely assumed, without discussing, that collateral could be aggregated across debtors. *See, e.g., In re Gen. Growth Props., Inc.*, No. 09–11977(ALG), 2011 WL 2974305, *1 n.3 (Bankr.S.D.N.Y. July 20, 2011); *In re Capmark Fin. Grp., Inc.*, 438 B.R. 471, 490, 501 (Bankr.D.Del.2010); *In re Dana Corp.*, 367 B.R. 409, 412 (Bankr.S.D.N.Y.2007); *In re Urban Communicators PCS Ltd. P'ship,* 379 B.R. 232, 244 (Bankr.S.D.N.Y.2007), *aff'd in part and rev'd in part on other grounds,*394 B.R. 325 (S.D.N.Y.2008); *In re Fiberglass Indus., Inc.,* 74 B.R. 738, 740 (Bankr.N.D.N.Y.1987).

40 While the court reached this conclusion in the context of a plan that provided for limited substantive consolidation under section 1123(a)(5)(C), the court seemingly reached its conclusion independently, rejecting the debtor's argument "particularly in view of the provisions of [the] Plan." *SW Hotel Venture,* 460 B.R. at 33.

In this case, given the facts that lead to the creation of the JSNs' liens, the Court believes that the Defendants' interpretation of section 506 best reflects reality and comports with the purpose underlying the Bankruptcy Code. The Plaintiffs argue that adopting the Defendants' suggestion that courts can "cavalierly pool collateral from multiple debtors" runs contrary to the plain text of the statute and the principle of law "deeply ingrained" in American corporate and bankruptcy jurisprudence that corporate separateness must be respected absent extraordinary circumstances. *See, e.g.,United States v. Bestfoods,* 524 U.S. 51, 61, 118 S.Ct. 1876, 141 L.Ed.2d 43 (1998) (refusing to disturb corporate separateness to penalize shareholders of polluting company). According to the Plaintiffs, "arbitrarily merging the assets and liabilities of multiple distinct entities would upset creditors' expectation that the assets of their debtor will be available to satisfy their claim." (Plaintiffs' Post Trial Brief, ECF Doc. # 186 at 66.) *See, e.g., Augie/Restivo,* 860 F.2d at 518–19 ("[C]reditors who make loans on the basis of the financial status of a separate entity expect to be able to look to the assets of their particular borrower for satisfaction of that loan."); *In re Tribune Co.*, 464 B.R. 126, 182 (Bankr.D.Del.2011) ("In the absence of substantive consolidation, entity separateness is fundamental.").

The Plaintiffs woefully mischaracterize the present situation. Only the value of the JSN Collateral would be used to satisfy their claims. They would have this Court ignore the reality of their business arrangement with the JSNs, in favor of a formulaic adherence to fictional corporate separateness. Far from "arbitrarily merging" assets of distinct entities, the Court is giving the JSNs the benefit of their bargain. The JSN Indenture explicitly provides that the JSNs are entitled to collect ***601** interest

until the principal was paid in full. (DX CN at 7; PX 1 at 51.) In the Offering Memorandum, the Debtors represented that the JSNs would be secured by ResCap and its subsidiaries, together, jointly and severally. (PX 175 at 1 ("The new notes will be issued by ResCap and will be secured by substantially all of our existing and after-acquired unencumbered assets remaining available to be pledged as collateral as described below. The notes will also be unconditionally guaranteed by subsidiaries of ResCap."); PX 1. at 79–80.) "Guarantor" is defined in the JSN Indenture as "(i) each of the Subsidiaries of the Company that is a party to this Indenture, and (ii) any other Subsidiary that executes a supplemental indenture in accordance with the provisions of this Indenture." (PX 1 at 14.) The Guarantors provided unconditional guarantees to the JSNs *jointly and severally*. (*Id*. at 79–80.) Additionally, the JSN Indenture required that if the Debtors moved assets to a Significant Subsidiary or created a Significant Subsidiary,[41] such Significant Subsidiary would become a Guarantor, subject to certain exceptions. (*See, e.g.,id*. at 59–60 (Section 4.17 requiring all "Significant Subsidiaries" to become "Guarantors" and thus also "Grantors" under the JSN Pledge Agreement).)

41 "Subsidiary" is defined in the JSN Indenture as "any corporation, partnership, limited liability company, association or other entity of which at least majority of the outstanding stock or other interest having by its terms ordinary voting power to elect majority of the board of directors, managers or trustees of such corporation, partnership, limited liability company, association or other entity (irrespective of whether or not at the time stock or other interest of any other class or classes of such Person shall have or might have voting power by reason of the happening of any contingency) is at the time owned by the Company, or owned by one or more Subsidiaries, or owned by the Company and one or more Subsidiaries (it being understood that GMAC Bank is not Subsidiary)." (PX 1 at 24.) "Significant Subsidiary" is defined in the JSN Indenture as any Subsidiary that met certain threshold conditions respecting the income or proportionate share of the total assets of the Company and Subsidiaries on a consolidated basis. (*Id*.)

Outside of bankruptcy court the JSNs would have been entitled to levy against the assets of any and all of the Obligors and Guarantors to secure their rights to collect interest until principal was paid in full. (*Id*. at 79–80.) The JSN Indenture explicitly states that the JSNs are entitled to collect postpetition interest in the event of a bankruptcy proceeding, to the extent allowed by law. (*Id*. at 51.) The JSN Indenture contains no provision conditioning those interest payments on the JSNs being oversecured at any single Debtor entity.

Additionally, the Debtors routinely reported their financial status in consolidated financial statements. (*See, e.g.,* DX GU; DX HQ; DX IT; DX JT.) The Debtors continued to report collateral value in the aggregate after the Petition Date. (*See, e.g.,* Monthly Operating Report for the Period from September 1, 2012 through September 30, 2012, ECF 12–12020 Doc. # 1914; Monthly Operating Report for the Period from August 1, 2013 through August 31, 2013, ECF 12–12020 Doc. # 5209.)

The Defendants' view more accurately reflects the reality of this case. It also reflects the workings of the business world at large. For example, like the JSN Indenture at issue here, most indentures allow debtors to move assets among their subsidiaries, and to create new subsidiaries, as long as the creditors continue to maintain liens in such assets. (See PX 1 § 4.7 (requiring all "Significant Subsidiaries" to become "Guarantors" and thus also "Grantors" under the JSN Pledge Agreement).) This flexibility is beneficial to borrowers, as it enables them to employ varying ***602** corporate structures in order to avail themselves of tax benefits, limit their liability, and comply with a multiplicity of regulatory requirements (for example, state laws requiring that construction or other permits be obtained by a domestic entity). *See, e.g.,In re Owens Corning,* 419 F.3d 195, 200 (3d Cir.2005) ("[Parent] and its subsidiaries (which include corporations and limited liability companies) comprise a multinational corporate group. Different entities within the group have different purposes. Some, for example, exist to limit liability concerns (such as those related to asbestos), others to gain tax benefits, and others have regulatory reasons for their formation."). For these Debtors, the use of special purpose subsidiaries was particularly necessary in order to allow the Debtors to obtain financing secured by mortgage loans. (*See* ECF 12–12020 Doc. # 1546 ¶ 49 ("Presumably to avoid the burden and expense of preparing and recording separate mortgages on each parcel of property, the Debtors are permitted to transfer real property to SPVs whose equity were pledged under the Security Agreements.").)

If, to be oversecured, and thus entitled to payment in full of all amounts owing, including postpetition interest, fees, costs, and charges in a bankruptcy case, secured lenders were required to be oversecured at a single entity, credit agreements and indentures might begin to prohibit corporate families from employing the type of complex subsidiary and affiliate structures

that are currently commonplace and borrowers will be required to hold all collateral at a single entity. Lenders might also require their approval before collateral could be moved among entities. Absent these precautions, lenders would be less willing to extend credit (especially to borrowers in precarious economic situations, who may be most in need of financing), or would charge higher interest rates to compensate for the possibility that their contractual rights to postpetition interest, fees, costs, and charges will not be honored in bankruptcy.

Moreover, if the Plaintiffs' view is accepted, section 506(b) will effectively be nullified in multi-debtor cases where a secured creditor is not oversecured at any single debtor, even in instances where the creditor is vastly oversecured by the property held by the debtors in the aggregate. An interpretation of section 506(b) that allows for this scenario defies common sense. For all of these reasons, the Court holds that the JSNs must be allowed to aggregate collateral held at each of the Debtors in order to calculate the extent of their security.

D. Since the Debtors Can Aggregate Collateral, the Court Must Determine What Constitutes JSN Collateral.

The parties agree to a $1.88 billion baseline valuation of the JSN Collateral on the Effective Date, but the Defendants want to add to that figure, and the Plaintiffs want to subtract from it. The analysis below addresses both the Defendants' attempts to add to their collateral along with the Plaintiffs' challenges to certain JSN liens on collateral.

1. The JSNs Are Not Entitled to Additional Sale Proceeds for the HFS Collateral.

The Defendants claim that the JSNs' liens attach to an additional $66 million of cash proceeds from the Berkshire sale, based on their expert's allocation of the sale price to the HFS loans. Mr. Fazio conducted an analysis of the value of the HFS loans sold to Berkshire, reaching a value that was $66 million higher than that provided by the Plaintiffs. Mr. Fazio testified that he did not rely on the pricing ***603** formula in the Berkshire APA, which broke the HFS loan portfolio into categories based on only one criterion, but instead looked at all the credit quality and credit statistics associated with each of the portfolios to determine value. (Oct. 22 Tr. 167:16–24.) In general, those statistics—including borrower credit rating, interest rate, and delinquency—were better for the JSN loan collateral than for the non-JSN Collateral. (*See* DX ABI at 5–7.)

The Court does not find Mr. Fazio's calculation the best indicator of the value of the HFS loans. In applying his own methodology to allocate the value of the HFS Portfolio between JSN and non-JSN Collateral, Mr. Fazio disregarded the actual purchase prices that Berkshire Hathaway agreed to pay for the collateral pursuant to § 3.1(a) of the Berkshire APA, which was an arm's-length agreement.[42] (PX 31 at 27.) The Berkshire APA classified the loans within the HFS Portfolio into six buckets based on certain characteristics: (1) Performing First Lien; (2) Non–Performing First Lien; (3) Performing Second Lien; (4) Non–Performing Second Lien; (5) Other; and (6) Securitized Advances. (Oct. 22 Tr. 161:20–162:11, 163:7–17; PX 31 at 19.) The Berkshire APA established different purchase prices calculated as percentages to be multiplied by the unpaid principal balance of the loans, for each category (plus any adjustments for the document deficiency multiplier). (Oct. 22 Tr. 162:12–19; 164:8–166:13; 167:25–168:18; PX 31 at 20.) Rejecting these contractual purchase prices, Mr. Fazio reclassified the loans based on characteristics such as origination vintage, product type, or adjustable or fixed rate mortgage, and valued the loans within his classifications based on metrics such as borrower credit scores and interest rates, to derive his bottoms-up valuation. (Oct. 22 Tr. 154:24–158:11, 159:3–9, 164:1–7, 169:2–10; DX ABI at 5, 19–22.)

42 Here, the Court distinguishes between allocation and calculation. As the Court already held in connection with the Ocwen APA, any purchase price allocation in the Berkshire APA was for tax purposes only. (PX 31 at 30.) This is distinct from the calculations relied upon here, which set out actual formulas for determining the amount Berkshire would eventually pay for different categories of loans.

[13] Where, as here, an asset is sold in an arm's-length transaction, the fair market value of such asset is conclusively determined by the price paid. *See Romley v. Sun Nat'l Bank (In re Two "S" Corp.),* 875 F.2d 240, 244 (9th Cir.1989); *see also Covey v. Davlin (In re Hobbick)*, No. 97–83543, 2001 WL 34076375, at *14 (Bankr.C.D.Ill. Sept. 10, 2001). The Berkshire APA was the result of a highly competitive auction process approved by the Court, and the price paid for the whole loans was the result

of arm's-length negotiations that established the fair market value of each category of loans. The Court will not rely on Mr. Fazio's reallocation of Berkshire's price calculation. The Court finds that the JSNs are not entitled to a lien on additional sale proceeds for the HFS loans.

2. The JSNs Are Entitled to a $17 Million Increase in FHA/VA Loan Value.

[14] The Defendants seek to add an additional $17 million to the baseline collateral, to reflect a net increase to the value of the FHA/VA loans. The difference between the Plaintiffs' and Defendants' valuations of the FHA/VA loans is attributable to their methodologies. The Plaintiffs' expert Mr. Renzi employed a recovery analysis, discounting the figures in the Debtors' April 30, 2013 balance sheet for assumed costs of collection. (Oct. 16 Tr. 139:5–11.) Mr. Renzi assumed a recovery rate of 91.1% of book value, deducting the costs, ***604** expenses and risks associated with disposing of the assets. (Renzi Direct ¶ 13; Oct. 16 Tr. 144:20–145:2.) The Defendants' expert Mr. Fazio employed a fair market value analysis. Mr. Fazio assumed that the loans would monetize over a 30–36 month period. (DX ABI at 59.) Mr. Fazio discounted the estimated cash flow at 5% over the three year period, taking into consideration the risk of loss and government insurance. (*Id.*) Ultimately, Mr. Fazio valued the FHA/VA loans at 95% of book value. (*Id.*) The Plaintiffs challenge Mr. Fazio's assumption that the loans would be runoff in three years, claiming that the Debtor documents on which he relied actually project a seven-year timetable. (Oct. 22 Tr. 169:15–175:8; DX ABI at 58; *see also* Puntus Direct ¶ 162.) Mr. Fazio stated at trial that while his calculations were based on a 100% monetization by the end of the third year, it is possible that some small "insignificant amount" of the loans would not be monetized until years later. (Oct. 22 Tr. 174:22–175:8.)

The Court believes that fair market value, and not recovery value, was the correct methodology for valuing the FHA/VA loans. Even if there are costs in monetizing the loans, the JSNs should not be charged with these costs when valuing the amount of their secured claim pursuant to section 506(b). Under section 506(b), postpetition interest, fees, costs and charges may only be offset by the amounts chargeable to collateral under section 506(c). 11 U.S.C. §§ 506(b)–(c). Here, there are no such costs under section 506(c) because the Debtors waived their section 506(c) rights in the Cash Collateral Order. (PX 76.) Thus, the premise of the Plaintiffs' recovery analysis—that the assets will continue to generate expenses and cost money to monetize—runs counter to section 506(b). The Court finds that the JSNs are entitled to a lien on an additional $17 million for the FHA/VA loans.

3. The JSNs Are Entitled to Another $40 Million in Liens on Non–Debtor Equity.

[15] The JSNs claim they have a lien on an additional $40 million of equity interests in non-Debtor subsidiaries. Their argument is based on a report filed by the Debtors, titled *Periodic Report Regarding Value, Operations and Profitability of Entities in Which the Debtors' Estates Hold a Substantial or Controlling Interest* (the "Periodic Report"), which included a summary balance sheet for each of the non-Debtor subsidiaries. (*See* DX ABI at 68–69.) Using the Periodic Report as a guide, Mr. Fazio concluded that the value of the equity pledges in non-Debtor Subsidiaries was approximately $40 million. (*Id.*) Specifically, Mr. Fazio calculated that the value of the equity pledges in the Non–Debtor subsidiaries were $26 million in CAP RE of Vermont, LLC; $3 million in CMH Holdings LLC; $1 million in GMAC–RFC Europe Limited; and $10 million in GMAC–RFC Holdings Limited. (*Id.*)

The Plaintiffs have not offered any evidence regarding these equity interests. At trial, Mr. Renzi testified that Plaintiffs' counsel told him that the non-Debtor subsidiaries had very limited equity value due to contingent liabilities, namely litigation liability. (Oct. 16 Tr. 153:16–154:3.) Plaintiffs' counsel further informed Mr. Renzi that the probability was high that the Debtors would not prevail in the litigation. (*Id.* at 154:4–9.) Instead of presenting a risk-adjusted equity value to account for the litigation risk at the Non–Debtor subsidiaries, based upon his conversations with counsel, Mr. Renzi presented the equity value in those entities as zero. (*Id.* at 153:12–154:15.)

Moreover, the Plaintiffs have not refuted that the JSNs have a lien on equity pledges. The Defendants have carried ***605** their initial burden of putting forth evidence to show they have an interest in the equity of these non-Debtor subsidiaries, in an amount totaling $40 million. The Plaintiffs' expert did not produce a value for the equity; Mr. Renzi simply valued the equity at "0." The Plaintiffs have therefore failed to put forth sufficient evidence to rebut the Defendants' claim. *See Heritage Highgate,* 679 F.3d at 140 ("It is only fair ... that the party seeking to negate the presumptively valid amount of a secured claim—and thereby affect the rights of a creditor—bear the initial burden.... If the movant establishes with sufficient evidence that the proof of claim overvalues a creditor's secured claim because the collateral is of insufficient value, the burden shifts."). The Court finds that the JSNs have a lien on $40 million of equity at non-Debtor entities.

4. The JSNs Do Not Have a Lien on Any Collateral Pledged to the AFI LOC.

The Defendants offer two arguments for why the JSNs have liens on approximately $910 million in collateral pledged to the AFI LOC. First, the Defendants claim that the collateral was previously pledged to the JSNs and was never properly released from the JSNs' liens, so their liens still attach to the collateral. Second, the Defendants assert that even if their liens on the collateral were released, paragraph 5(g) of the Cash Collateral Order revived those liens. Both arguments fail.

a. All JSN Collateral Subsequently Pledged to the AFI LOC Was Properly Released Before Being Pledged to the AFI LOC.

In 2010 and 2011, Wells Fargo, acting as Third Priority Collateral Agent (i.e., the collateral agent for the Junior Secured Notes) consented in writing to the release of a variety of assets from the Notes Collateral that were then pledged to AFI under the LOC Facility. Wells Fargo did this by executing the Blanket Loan Release, which released the JSNs' security interest in the Released Loan Collateral, and the Servicing Advance Release, which released the JSNs' security interest in the Released Advances. Wells Fargo then filed U.C.C.–3 amendments that deleted the Blanket Released Collateral from the collateral provided in the original U.C.C.–1 financing statements (as amended) filed by the Third Priority Collateral Agent.

The Defendants previously contested the effectiveness of those releases. The Court rejected the Defendants' arguments, holding that the releases were effective and entitled to enforcement. *See Residential Capital,* 497 B.R. at 416–17. Specifically reviewing the Blanket Loan Release—which accounts for approximately 97% of the $910 million in dispute—the Court found that the descriptions of the collateral covered by that release satisfied U.C.C. 9–108(b)'s requirement for reasonably identifying the released collateral, and the U.C.C.–3s "are therefore valid." *Id.* at 418.

At trial, the Defendants tried to attack the releases of the collateral pledged to the AFI LOC by arguing that there was an insufficient paper trail documenting the releases. This is not so. The Blanket Loan Release released, among other things, "Servicing Rights Collateral" and "Subject Mortgage Loans." The releases provided three means for determining whether an asset was a Subject Mortgage Loan that had been released from the Revolver and Junior Secured Notes:

- a "Mortgage Schedule delivered under the LOC Loan Agreement";
- in the backup to the monthly borrowing base reports or monthly collateral reports under the LOC Loan Agreement, which reflected the carrying value ***606** of the assets pledged to the LOC Facility; or
- most broadly, any of the Debtors' "books and records" reflecting that a loan had been pledged to the LOC Facility. This category would include, among other things, the CFDR, which tracked various details concerning the Debtors' loans, including the facility (if any) to which such loans were pledged.

(PX 134.)

Under these terms, if a loan was listed on the CFDR as pledged to the AFI LOC, it was covered by the Blanket Loan Release. There is no dispute that the collateral in question was listed in the CFDR as pledged to the AFI LOC. The Court has already admitted the CFDR as a reliable record that was subject to rigorous audits and controls. Therefore, the releases were effective since the loans appeared in the CFDR as pledged to the AFI LOC. Moreover, a written description of the released collateral was attached as an exhibit to the U.C.C.–3 amendments, which the Third Priority Collateral Agent also filed to delete the Blanket Released Collateral from the collateral set forth in the original U.C.C.–1 financing statements. These written descriptions put all potential creditors on notice that the collateral they covered includes certain servicing rights and mortgage loans (among other assets), and that further diligence may be required to determine to whom they are pledged. As the Court has explained, the U.C.C.–3s are sufficient to satisfy the lenient description standards outlined in U.C.C. § 9–108(b)(6) because the descriptions of the collateral released "reasonably identif[ied]" the collateral released, satisfying the U.C.C. permissive standard. *See Residential Capital,* 497 B.R. at 418.

The Court's conclusion applies with equal force to the Servicing Advance Release. Like the Blanket Loan Release, the Servicing Advance Release contained a description of various categories of Released Advances that were being released from the JSNs' liens, which included, among others, any existing and future advances relating to mortgage loans and REO property, made pursuant to certain contracts with Freddie Mac. Moreover, the Servicing Advance Release described all servicing advances pledged to the AFI LOC.

The Defendants contend that other back-up documentation should exist regarding the release of this $910 million of assets, including schedules of mortgage loans, collateral addition notices to the LOC Facility, and electronic templates used to update the CFDR. But there is no need for this type of additional back-up. The CFDR suffices for the Blanket Loan Release, and the Servicing Advance Release effectively released all advances pledged to the AFI LOC.

b. Paragraph 5(g) Did Not Revive Any Liens on Collateral Pledged to the AFI LOC or to Any Other Previously Released Collateral.

[16] The Defendants ask the Court to interpret paragraph 5(g) of the Cash Collateral Order to mean that the Debtors agreed that assets released from the JSNs' liens years earlier were revived by the Order. If so, the Defendants would have a lien on the collateral pledged to the AFI LOC, totaling an additional $1.1 billion in value. In ruling on the motions to dismiss, the Court determined that it would benefit from a greater factual record on this issue, and extrinsic evidence could be submitted to establish the meaning of paragraph 5(g). *Residential Capital,* 497 B.R. at 403. Based on the evidence submitted by both sides, the Court concludes that the Defendants' interpretation of paragraph 5(g) fails on multiple grounds.

First, the Court notes that no party ever disclosed this purported effect of paragraph ***607** 5(g) to the Court when the Cash Collateral Order was proposed or at any contemporaneous hearing, despite Local Rule 4001–2(a)(6). That rule requires disclosure of provisions in a cash collateral motion that would secure prepetition debt with liens on assets that the creditor would not otherwise have by virtue of the prepetition security agreement or applicable law. The Court will not countenance the Defendants' attempt to slide a $1.2 billion windfall past the Court and past the Plaintiffs.

Second, other portions of the Cash Collateral Order reveal the parties' intent at the time the order was submitted. For instance, the very next stipulation in the Cash Collateral Order provides an overview of the collateral securing the Junior Secured Notes:

> [T]he collateral securing the Junior Secured Notes Obligations includes, among others ... the categories of assets under the columns labeled "Ally Revolver" and "Blanket" set forth on Exhibit A to this Final Order....

(PX 76 at 12.) If, at the time the Cash Collateral Order was negotiated, the JSNs actually believed that they were being granted new liens on the AFI LOC collateral, paragraph 5(h) should have included "AFI LOC" in the categories of assets securing the Junior Secured Notes on Exhibit A to the Cash Collateral Order.

Moreover, the Defendants reading of Paragraph 5(g) is also not supported by the language of the Cash Collateral Order. For example, in Paragraph 5(g), the Debtors acknowledge that the JSNs' liens are "subject and subordinate *only* " to the liens granted under the Revolver. (*Id*. at 11–12 (emphasis added).) This provision does not also subordinate JSNs' purported lien to the LOC Lenders' lien under the LOC Facility. Under the Defendants' proposed interpretation of Paragraph 5(g), the JSNs' purportedly revived lien on the AFI LOC collateral is elevated ahead of the LOC Lenders' (uncontrovertibly senior) lien in that collateral. AFI would not have agreed to such a provision, especially since it relied on the AFI LOC collateral to make the postpetition advances under the Cash Collateral Order.

In addition, in granting the JSNs a postpetition adequate protection lien on the Revolver Collateral and the AFI LOC collateral, the Cash Collateral Order subordinated adequate protection liens to any *existing* liens on the same collateral. To that end, with respect to the JSNs' adequate protection lien on the Revolver Collateral, the order acknowledges that the adequate protection lien is junior to (among other things) the "*existing liens granted to the Junior Secured Parties*." (*Id*. at 28 (emphasis added).) But the order does not contain similar language with respect to the adequate protection lien in the AFI LOC collateral, indicating that the JSNs did not have an existing lien on that collateral. (*Id*. at 28–29.)

Aside from the terms of the Cash Collateral Order, other documents filed simultaneously in the bankruptcy court reflect that the stipulations in paragraph 5(g) were not intended to revive previously released liens. For example, the Debtors indicated in their motion seeking approval of the Barclays DIP Facility that any purported equitable lien asserted by the JSNs on the assets securing the AFI LOC was not a valid, perfected, and nonavoidable lien or security interest as of the Petition Date. (PX 88 at 55.) Offering that argument is squarely at odds with a purported stipulation to the validity of a lien on that collateral.

Third, the testimony of Mr. Siegert indicates that when the parties were negotiating the Cash Collateral Order, the JSNs did not believe that the Order would revive liens on more than $1 billion in released ***608** collateral. The JSNs did not include the value of the assets securing the AFI LOC in their own contemporaneous analysis of the collateral securing the Junior Secured Notes. On cross-examination, Mr. Siegert was shown a Houlihan presentation dated May 14, 2012, which was prepared immediately before the Petition Date. (PX 169; Oct. 23 Tr. 110:8–23.) That presentation valued the JSNs' collateral. Mr. Siegert acknowledged that if the counsel for the JSNs had concluded that the Debtors had stipulated to JSN liens on the AFI LOC collateral, that would have been a material fact for Houlihan to consider when presenting estimates of the value of the JSN Collateral. (Oct. 23 Tr. 127:25–128:21.) And further, that would have been a material fact for Houlihan to convey to the JSNs. (*Id*.) But the May 14 Houlihan presentation did not reflect any liens on the AFI LOC collateral. (*Id*.)

It defies the parties' conduct and the terms of the Cash Collateral Order to argue that paragraph 5(g) revived previously leased liens. The JSNs do not have a lien on any AFI LOC collateral by virtue of paragraph 5(g).

5. General Intangibles

The Defendants argue that the value of the JSN Collateral on the Effective Date should increase beyond the $1.88 baseline valuation because the baseline valuation does not account for certain JSN liens on intangible assets. Specifically, the Defendants argue that the Debtors sold intangible assets subject to JSN liens during the Ocwen asset sale, but the Debtors did not allocate any portion of the proceeds to intangibles subject to JSN liens. These intangibles include software, certain refinancing opportunities, trademarks, and goodwill. According to the Plaintiffs, Ocwen and Walter did not place any value on these intangibles, so it is not proper to allocate any proceeds to intangible value. Further, the Plaintiffs argue that to the extent the JSNs had any lien on goodwill, that goodwill was created postpetition and is not subject to any JSN lien. The Defendants respond that they had a lien on assets sold to Ocwen, but have received no benefit of the sale simply because the Ocwen APA assigned no value to the intangibles, even though the Ocwen APA provided that Ocwen and Walter were buying "goodwill and other intangible assets." (PX 19.) According to the Defendants, the Court may still assign value to the intangible assets based on the work of the Defendants' expert Mr. Taylor, who used general accounting principles to value the intangible assets.

a. The JSNs Had Liens on Software Sold to Ocwen.

In the JSN Security Agreement, the JSNs were specifically granted a lien on computer software as well as general intangibles. (*See* PX 4.) The Debtors used software in connection with the PLS MSRs and the GSE MSRs. (Oct. 15 Tr. 171:10–12.) The Plaintiffs argue the JSNs' lien on software associated with the PLS MSRs was released under the May 14, 2010 Blanket Release. That release specifically stated that all general intangibles were released "if and to the extent related to the Servicing Rights Collateral" (i.e., the PLS MSRs). (PX 134 at 6.) The Defendants counter, though, that "Servicing Rights Collateral" was defined to specifically exclude computer programs. (*Id*. at 8.) The Court therefore finds that the JSNs' lien on software associated with the PLS MSRs was not released by virtue of the Blanket Release. Any value associated with software sold to Ocwen and Walter would be allocable to the JSNs as JSN Collateral.

The next question is how to value the collateral. The Defendants' expert Mr. Taylor endeavored to value the Debtors' ***609** software and associated know-how by using an accounting method that considers what a typical market participant would have paid for the asset, regardless of any particular incentives (e.g., synergies) or disincentives that may have existed in the market at the time. The Plaintiffs challenged Mr. Taylor's analysis on several grounds, including that (1) Mr. Taylor's analysis ignores the allocations of assets in the Ocwen APA; (2) the Debtors gave Ocwen and Walter a substantial bid credit (exceeding $100 million) so Ocwen and Walter would buy the Debtors' servicing platform, including the software; (3) Ocwen and Walter later attributed lower values to software, ostensibly using the same accounting principles that Mr. Taylor applied; (4) Mr. Taylor's "avoided cost" analysis assumed that Ocwen and Walter planned to use the Debtors' software for three years, contrary to Ocwen's and Walter's actual plans; and (5) Mr. Taylor put inordinate weight on certain precedent transactions when applying his "relief from royalty method."

First, the Court finds that the allocations in the Ocwen APA do not control here. Section 3.3(b) of that APA provided that the Debtors and Ocwen were bound by the allocations for tax purposes, "*but not for any other purpose*." (PX 19 at 50 (emphasis in original).) *Second*, the Debtors' bid credit awarded to Ocwen did not render the Debtors' software valueless. Rather, Ocwen and Walter intended to use and did use the Debtors' software associated with the platforms they were buying. Their public filings attributed value to software, whether as a standalone asset or built into the premises and equipment asset category.[43] (*See* DX ZH at 9; DX ST at 3; DX WK at 13.) Therefore, the software had and provided value.

43 As explained in Mr. Taylor's report, Ocwen engaged a third-party valuation expert (Applied Economics) to appraise the fair value of certain assets. (DX ABH; DX ST.) Applied Economics considered the ResCap software to be worth $1.295 million (DX ST at 3), and that figure served as a portion of the "premises and equipment" allocation in Ocwen's 10–Q reporting on the ResCap sale.

Turning to Mr. Taylor's analysis, the Court is not satisfied with his valuation of the software and associated know-how. The Plaintiffs are correct that Mr. Taylor's avoided cost analysis unreasonably assumes a duration of software use that is contrary to the actual intended use in the Ocwen and Walter sale. As for his "relief from royalty" analysis, the Plaintiffs sufficiently demonstrated flaws in Mr. Taylor's methodology. For example, Mr. Taylor gave no weight to certain transactions between seemingly related parties because those may not have been arm's-length deals. (DX ABH at 135.) But Mr. Taylor then attributed 33.34% of his outcome to a transaction that appears to be between related parties. (*Id*.) Not only is this transaction given greater weight than any other transaction, but it is also a significant outlier in terms of its "point estimate." (*Id*.) Simply removing Mr. Taylor's weight assigned to this transaction would yield a $100 million lower software value. Thus, the Court finds that Mr. Taylor's "relief from royalty" analysis is unreliable.

Rather than relying on Mr. Taylor's analysis, the Court turns to how Ocwen and Walter actually reported the value of the software using a fair value accounting method. Walter's public filings indicate a $17.1 million value for software (DX WK at 13), and Ocwen's filing and its third-party valuation reflect a $1.295 value for software (DX ZH at 9; DX ST at 3.) The Court therefore finds that $18.395 million of the Ocwen sale proceeds should be attributed to JSN liens on software.

***610 b. The JSNs Have a Lien on the Tradename, Iconography, and Logotype Associated With the Assets Sold to Ocwen and Walter.**

The Defendants submitted expert evidence that $10 million of proceeds from the Ocwen and Walter sale was allocable to "tradename/marks, iconography and logotype." (DX ABH at 42–45.) The Plaintiffs did not rebut this analysis at trial. Mr. Taylor notes that the Ocwen APA required the purchasers to rebrand assets within 120 days, but a 10–Q filed by Walter shows that it attributed value to tradename with an estimated eight-year life. (DX ABH at 43.) Thus, there may have been some intangible tradename or logotype value that would not cease to exist after 120 days. The Plaintiffs did not rebut this contention. Nor did the Plaintiffs demonstrate that any tradename value was associated only with the Servicing Rights Collateral or Subject Mortgage Loans and would therefore have been released in the Blanket Release. The Court is satisfied with Mr. Taylor's valuation of the intangible tradename assets associated with the Ocwen sale and finds that a $10 million allocation to the JSNs' liens is appropriate.

c. The Defendants Do Not Have a Lien on Refinancing Opportunities Associated With GSE MSRs.

[17] At trial, the Defendants' expert Mr. Levine testified to the value of refinancing opportunities associated with certain GSE MSRs. The JSNs do not have liens on GSE MSRs since those are Excluded Assets, but the Defendants argue that the JSNs have a lien on intangible assets associated with GSE MSRs. Although the Defendants may be correct that the JSNs could have a lien on intangible assets absent a lien on an underlying asset, the value created by refinancing opportunities is inherent to the value of the GSE MSRs. In other words, the opportunities are not a separate intangible asset.

Mr. Levine testified that he regularly values refinancing opportunities separately from servicing rights. (Oct. 22 Tr. 100:9–16.) Even so, the value of the refinancing opportunities are inextricably linked to the MSRs themselves: Mr. Levine conceded that "to the buyer of the servicing, there would not be value to the HARP [refinancing opportunities] without the servicing rights." (*Id*. at 91:11–23.) In fact, Mr. Levine had never seen an instance where refinancing opportunities were sold separately from servicing rights. (*Id*. at 101:9–11.) Therefore, the value is properly attributable to the GSE MSRs themselves. As such, the JSNs do not have a lien on any refinancing opportunities.

d. The JSNs Did Not Establish the Value of Their Lien on Goodwill as of the Petition Date.

[18] The JSNs argue that they have a lien on goodwill associated with the Debtors' assets sold to Ocwen. Goodwill is "an intangible asset that represents the ability of a company to generate earnings over and above the operating value of the company's other tangible and intangible assets." *In re Prince,* 85 F.3d 314, 322 (7th Cir.1996). Goodwill may include "name recognition, consumer brand loyalty, or special relationships with suppliers or customers." *Id*. To calculate the value of goodwill, generally accepted accounting principles ("GAAP") look to "any excess of [a] purchase price over the fair value of the assets acquired and the liabilities assumed." *Fait v. Regions Fin. Corp.,* 655 F.3d 105, 110 (2d Cir.2011). Although GAAP does not require a company to record internally developed goodwill absent an asset sale, *see Sanders v. Jackson,* 209 F.3d 998, 1001–02 (7th Cir.2000), the existence of goodwill does not depend on an asset sale. *See Prince,* 85 F.3d at 323–24 ***611** (describing valuation of goodwill in context of assigning value to company stock); *see also Ackerman v. Schultz (In re Schultz),* 250 B.R. 22, 29 (Bankr.E.D.N.Y.2000) (valuing goodwill outside context of asset sale). So the question becomes whether any goodwill existed on the Petition Date subject to JSN liens.

The Defendants use two methods to calculate goodwill on the Petition Date. First, they look to the Ocwen and Walter asset sale and calculate a present value of the goodwill in that sale as of the Petition Date. Second, the Defendants perform a "top down" analysis of the intangibles associated with the MSRs and servicing and originating platforms, including goodwill. While

Houlihan's methodologies may have been textbook, the assumptions and inputs they used were seriously flawed. As a result, Houlihan's conclusions regarding the values of intangibles and goodwill are not credible.

Regarding the first method, the Court cannot conclude that any goodwill derived from the Ocwen and Walter sale existed on the Petition Date. The value of the Debtors' assets on that date was seriously impaired, subject to steep reductions in value by litigation risks, potential seizure of certain MSRs, and termination of rights and setoff by the RMBS Trustees. Ocwen and Walter, the eventual buyers, were not committed to paying the Debtors anything for their assets on the Petition Date, let alone a price above the fair value of the Debtors' assets and liabilities. The Debtors facilitated the asset sale to Ocwen and Walter by maintaining the value of the assets throughout the bankruptcy, along with decreasing the liabilities associated with those assets. The Debtors worked very hard at substantial expense to achieve settlements and consents that allowed the sales to close. If the Debtors had not taken those actions, Ocwen and Walter may not have bought any assets at all, and likely would not have paid any price above the fair value of the assets and liabilities. To be sure, there may have been name recognition or special market relationships associated with the Debtors' assets on the Petition Date, but that name recognition or those relationships could have been valueless in the eyes of a buyer on the Petition Date. The Court cannot indulge the speculation that the Ocwen and Walter purchase price provides an adequate starting point for the goodwill that would have been generated by an asset sale on the Petition Date. After all, "goodwill often fluctuates widely for innumerable reasons." *Sanders,* 209 F.3d at 1002.

As for the "top down" valuation, the Plaintiffs raised serious problems with the Defendants' market multiple analysis that provided the starting point for the "top down" valuation. *First,* the Defendants' expert Mr. Fazio acknowledged that his market multiple analysis only weighed comparable companies in terms of their equity, rather than their total enterprise value. (Oct. 22 Tr. 198:20–199:6; 199:19–22.) *Second,* Mr. Fazio's analysis failed to account for any value that would be attributable to the Debtors' servicing advances. (Oct. 22 Tr. 200:1–22; DX ABG at 35, 38, 41.) Since those assets were not properly accounted for, and were not properly deduced from Mr. Fazio's valuation, it is possible that what the Defendants concluded was goodwill actually represented value attributable to servicing advances. Thus, the Defendants' second method for determining goodwill is unpersuasive.

Having failed to provide an adequate basis for valuing goodwill on the Petition Date, the JSNs have not met their burden in demonstrating the extent of their lien on goodwill as of the Petition Date.

***612 e. The JSNs Do Not Have a Lien on Goodwill Generated after the Petition Date.**

[19] Although the JSNs have a lien on the proceeds of their prepetition collateral, any goodwill generated in connection with the assets sold to Ocwen and Walter was not the proceeds of that collateral and is not subject to JSN liens. Bankruptcy Code Section 552(b) provides that if a prepetition security agreement extends to proceeds of collateral, then postpetition proceeds would also be subject to that security agreement, unless the court orders otherwise after a hearing based on the equities of the case. 11 U.S.C. § 552(b). The JSN Security Agreement granted the JSNs a lien on "all Proceeds, products, offspring, rents, issues, profits and returns of and from, and all distributions on and rights arising out of any of the [collateral described in the JSN Security Agreement]." (PX 4 at 17.) Additionally, the Cash Collateral Order provided that the proceeds of prepetition JSN Collateral are "deemed to be cash collateral of the [JSNs]." (PX 76 at 22.) To establish a lien on the goodwill created by the Ocwen sale, the JSNs would need to demonstrate that the goodwill was the product of their prepetition collateral. They did not meet this burden.

"Section 552(b) is intended to cover after-acquired property that is directly attributable to prepetition collateral, *without addition of estate resources*." 5 COLLIER ON BANKRUPTCY ¶ 552.02[2][a] (emphasis added). Here, even if JSN Collateral was used to generate goodwill (either by maintaining or improving the value of assets or by diminishing liabilities), Debtor resources were used as well. The Debtors improved the value of the assets sold to Ocwen by negotiating settlements with government entities and RMBS Trustees. That involved time, effort, and expense by the Debtors' estates. The Debtors did not merely take some JSN Collateral and convert it into goodwill without any other resources. That means that the goodwill is not the proceeds of JSN

Collateral. *See In re Delco Oil, Inc.,* 365 B.R. 246, 250 (Bankr.M.D.Fla.2007) ("The concept of proceeds is only implicated when one asset is disposed of and another is acquired as its substitute.") (internal quotation marks omitted). Even if a portion of the goodwill was directly attributable to JSN Collateral, without any other additional resources, the JSNs have failed to separate the value of that goodwill. Thus, the JSNs have not met their burden of establishing a lien on goodwill generated postpetition.

6. Miscellaneous Collateral Categories

a. The JSNs Have Liens on the "Contested Assets."

[20] The JSNs claim to have liens on "Contested Assets," which consist of (1) the Former Bilateral Facilities Collateral and (2) the Reacquired Mortgage Loans. The Court has previously ruled that the JSN Security Agreement is ambiguous with respect to "whether an Excluded Asset becomes part of the Secured Parties' collateral pursuant to the All–Asset Granting Clause once it ceases to constitute an Excluded Asset." *Residential Capital,* 495 B.R. at 262. Where a contract is ambiguous, courts may consider extrinsic evidence in order to determine the parties' intended meaning. *See Bank of New York Trust Co., N.A. v. Franklin Advisers, Inc.,* 726 F.3d 269, 276 (2d Cir.2013) (stating that a principle of New York contract law is that, "if contract terms are ambiguous, the court may accept any available extrinsic evidence to ascertain the meaning intended by the parties during the formation of the contract") (citations omitted). Extrinsic evidence can include testimony of the parties' intent. *See* ***613** *Webb v. GAF Corp.,* 936 F.Supp. 1109, 1124 (N.D.N.Y.1996) ("The court is of the opinion that testimony regarding the understandings of the parties ... was both competent and helpful to the triers of fact....").

Having the benefit of a full evidentiary record, including an examination of both the contractual language and the extrinsic evidence provided by witness testimony, the Court concludes that the JSN Security Agreement grants the JSNs liens on the Contested Assets.

i. The JSNs Have Liens on the Collateral Released from the Bilateral Facilities.

The Plaintiffs argue that the JSNs do not have a lien on the Former Bilateral Facilities Collateral, which has an alleged fair market value of approximately $24 million.[44] The Plaintiffs argue that the JSNs were never granted liens in the Former Bilateral Facilities Collateral because the underlying loans were originally Excluded Assets. Additionally, the Plaintiffs assert that no "springing lien" exists with respect to the Former Bilateral Facilities Collateral and, even if it did, the JSN Security Agreement is ambiguous whether the Former Bilateral Facilities Collateral automatically reverted to JSN Collateral before the Petition Date when the reason for the exclusion of the Former Bilateral Facilities Collateral no longer existed. The Plaintiffs contend that the testimony presented at trial did not sufficiently establish a course of dealing among the parties. The Defendants argue that even though the Former Bilateral Facilities Collateral consists of assets that were carved out of the JSN Collateral as "Excluded Assets" at the time the JSN Security Agreement was executed, the collateral was subsequently released from Bilateral Facilities before the Petition Date and treated as AFI and JSN Collateral. The Court finds that the JSNs have liens on the Former Bilateral Facilities Collateral.

44 This total does not include the $25 million of BMMZ assets that JSNs claim a lien on and that were subject to an earlier motion to dismiss.

The JSN Security Agreement provides that "the 'Collateral' ... shall not include Excluded Assets." (PX 4 § 2.) "Excluded Assets" in turn means, in relevant part:

> (c) any asset ... to the extent that the grant of a security interest therein would violate applicable Requirements of Law, result in the invalidation thereof or provide any party thereto with a right of

> termination or default with respect thereto or with respect to any Bilateral Facility to which such asset is subject as of the Issue Date....

(*Id*. at 4–15).

The testimony presented at trial revealed that employees for both the Debtors and AFI understood the JSN Security Agreement and the All–Asset Granting Clause to convert the Former Bilateral Facilities Collateral to Notes Collateral when the Bilateral Facilities terminated or when collateral was released from those facilities. The witnesses also testified that once an asset that otherwise fell within the scope Blanket Lien was released from a Bilateral Facility, that asset would become part of the JSN Collateral. Lara Hall testified at her deposition that "AFI's intent was as soon as the assets rolled off the bilateral facility, they would become subject to the blanket lien." (Hall Dep. 123:19–23.) She also said that "[t]he blanket lien basically suggested that anytime an asset became uncovered, it would be subject to the blanket lien." (*Id*. at 116:6–14.) Joseph Ruhlin, the Debtors' former Treasurer, testified in his deposition that the Debtors understood the Former Bilateral Facilities Collateral "would be covered by the blanket lien as long as they ... were owned [by the Debtors] and not ***614** pledged elsewhere to another bilateral facility," and that the Debtors' "understanding" was that "once an asset was released from a funding facility, depending on the asset, it would become part of the blanket lien." (Ruhlin Dep. 89:14–25; 93:8–14, 165:5–9.) Ms. Farley, the Debtors' appointed 30(b)(6) witness on the assets constituting JSN Collateral, testified that Former Bilateral Facilities Collateral would "absolutely" become JSN Collateral when the Bilateral Facilities terminated, "[t]o the extent they fell within the security grant." (Oct. 16 Tr. 186:24–187:9.)

Finally, the Debtors were told by their outside counsel via email in December 2008 that "if at any point while owned by GMAC [ ] the assets are removed from a Bilateral Facility, the [AFI] Revolver and [JSN] Indenture liens may cover these assets and they will constitute Collateral (if and to the extent Sections 9–406/8 of the U.C.C. are applicable)." (DX ES at 1.) The extrinsic evidence presented at trial indicates that the parties to the JSN Security Agreement understood and intended that the JSN Collateral would include Former Bilateral Facilities Collateral. The Court therefore finds that the JSNs have liens on the Former Bilateral Facilities Collateral.[45]

45 The Court already dismissed the Committee's attempt to recharacterize the BMMZ assets as Debtor assets. *Residential Capital,* 495 B.R. at 261. In its opinion, the Court rejected the Committee's contention that the BMMZ collateral was pledged to a bilateral facility as of the Petition Date. In fact, the Debtors did not own the BMMZ collateral on the Petition Date.

ii. The JSNs Have Liens on the Released and Reacquired Collateral.

The Plaintiffs seek a declaration that the Defendants have not perfected any interest in the Reacquired Mortgage Loans. According to the Plaintiffs, even if the JSNs retained a continuing security interest in the Released Mortgage Loans when those assets were re-acquired by the Debtors, which the Plaintiffs contest, the JSNs never perfected their security interest, and it is avoidable. The Defendants contend that (1) the Reacquired Mortgage Loans are assets that were initially JSN Collateral, subsequently released by the Collateral Agent in May 2010 so that they could be sold to a Repo Facility, and then reacquired by the Debtors between September 2010 and the Petition Date, thereby falling within the scope of the Blanket Lien, and (2) the JSNs' lien on the Reacquired Mortgage Loans is perfected because the original U.C.C. filings perfecting those liens provided adequate notice to potential creditors. The book value of the Reacquired Mortgage Loans is approximately $14.1 million and has an alleged fair market value of approximately $10 million.[46]

46 The Reacquired Mortgage Loans are distinct from the $910 million of loans in the AFI LOC.

The Court finds that the Defendants have perfected liens on the Reacquired Mortgage Loans.

(a) The Reacquired Mortgage Loans Fall within the Blanket Lien's Grasp.

[21] The Defendants argue that the loans that were released from the JSNs' liens in May 2010 to be sold to the Citi and Goldman Repo Facilities and subsequently repurchased by the Debtors between September 2010 and the Petition Date are JSN Collateral due to the Blanket Lien. The Blanket Lien arises from the All–Assets Granting Clause expressly covering all of the Debtors' assets, "whether not or hereafter existing, owned or acquired and wherever located and howsoever created...." (JSN Security Agreement at 13.) "[U]nder the Uniform Commercial Code, ***615** the proper perfection of a security interest may create an enforceable lien in after-acquired property, without regard to any entitlement to an equitable lien under common law." *In re Minor,* 443 B.R. 282, 288 n.3 (Bankr.W.D.N.Y.2011) (citing N.Y. U.C.C. § 9–204 (2001)). A security interest "arising by virtue of an after-acquired property clause is no less valid than a security interest in collateral in which the debtor has rights at the time value is given ... no further action by the secured party—such as a supplemental agreement covering the new collateral—is required." N.Y. U.C.C. § 9–204 cmt. 2 (2013).

No language in the JSN Security Agreement suggests that the Blanket Lien does not apply to ***616** the Reacquired Mortgage Loans. Instead, the Debtors' and AFI's employees testified that they understood that assets sold and repurchased by the Debtors would become JSN Collateral upon their reacquisition. (*See* Oct. 16 Tr. 190:21–191:24 (when an asset that had been released from the JSN Collateral package to be sold to a third party was repurchased by the Debtors, "the blanket lien would pick it up"); Ruhlin Dep. 65:19–22, 66:6–14 ("[A]ssets such as loans that were acquired in the future would be subject to the lien," and those assets could have been "[r]epurchases ... previously owned by ResCap," or "[t]hey ... could be repurchased outside from a third party.").) Thus, under the Blanket Lien, the Reacquired Mortgage Loans became JSN Collateral when the Debtors repurchased them.

(b) The JSNs' Interest in the Reacquired Mortgage Loans Is Perfected.

[22] The Plaintiffs argue that the U.C.C.–3 statements filed in May 2010 terminated the U.C.C.–1 financing statements as to these assets, rendering any security interests the JSNs had in the Reacquired Mortgage Loans unperfected. However, because the Court finds that the U.C.C.–1 financing statements continued in effect notwithstanding the filing of the U.C.C.–3 financing statements, the U.C.C.–1 statements operated to perfect the JSNs' security interests.

The U.C.C. employs a notice filing system requiring that a financing statement provide "a simple record providing a limited amount of information" that puts parties on notice to inquire further to ascertain "the complete state of affairs." N.Y. U.C.C. § 9–502 cmt. 2. "UCC Article 9 only requires information sufficient to engage in further inquiry. When the authorization underlying a previously filed termination statement matters to a subsequent lender (as it usually will), the lender can simply include any necessary further inquiry as part of its due diligence." *Official Comm. v. JPMorgan Chase Bank, NA (In re Motors Liquidation Co.),* 486 B.R. 596, 644 (Bankr.S.D.N.Y.2013). In cases where courts have addressed inconsistent financing statements, courts have found that the inconsistency in the statements itself was sufficient to put the creditor on notice. *See In re A.F. Evans Co.,* No. 09–41727(EDJ), 2009 WL 2821510, at *5 (Bankr.N.D.Cal. July 14, 2009) ("Here, CNB's financing statements, as amended by the U.C.C.–3 Amendment statements, each with two conflicting boxes checked [(a termination box plus a release of collateral box)], would raise a red flag for any person conducting a search alerting such person of the possibility that a full termination may not have been intended.").

In this case, because the U.C.C.–1s were on file, potential lenders were on notice to investigate the extent of the JSNs' security interest in the Reacquired Mortgage Loans notwithstanding the U.C.C.–3s relating to those assets. After further inquiry, they would have been informed that the Reacquired Mortgage Loans were automatically pledged once again to AFI and the JSNs under the Blanket Lien, and were coded first as unpledged and later as Blanket Lien Collateral in the CFDR. (*See* Farley Dep. 95:3–14, 110:5–111:14, 115:4–14, 137:21–24, 138:4–11, 176:21–177:3; Oct. 16 Tr. 190:21–192:18; Hall Dep. 117:6–12; Ruhlin Dep. 65:19–22, 66:6–21, 106:8–12, 119:4–9, 155:16–156:2, 156:15–21.)

For the foregoing reasons, the Court finds that the JSNs' interest in the Reacquired Mortgage Loans was perfected, and the JSNs are entitled to their lien on the released and reacquired collateral.

b. The JSNs Have Liens on a Portion of the Deposit Accounts.

[23] The Plaintiffs also challenge JSN liens on certain deposit accounts, which the Plaintiffs refer to as "Avoidable Deposit Accounts."[47] The Avoidable Deposit Accounts hold approximately $48.4 million. The Plaintiffs allege that the JSNs have not perfected their security interests in the Avoidable Deposit Accounts.

47 Account Nos. xxxx7286, xxxx3803, xxxx6323, xxxx9917, xxxx9454, xxxx4806, xxxx2482, xxxx2540, xxxx2565, xxxx2573, xxxx1781, xxxx1799, and xxxx1718. (Plaintiffs' Proposed Findings of Fact ECF Doc. # 187 at ¶ 293.)

[24] The Court finds that, except for the Controlled Accounts and the WF Accounts, the JSNs do not have perfected liens on the Avoidable Deposit Accounts. Under the U.C.C., "a security interest in a deposit account may be perfected only by control" of the account. N.Y. U.C.C. § 9–312(b)(1). A secured party has control of a deposit account if: "(1) the secured party is the bank with which the deposit account is maintained; (2) the debtor, secured party, and bank have agreed in an authenticated record that the bank will comply with instructions originated by the secured party directing disposition of the funds in the deposit account without further consent by the debtor; or (3) the secured party becomes the bank's customer with respect to the deposit account." *Id.* at § 9–104(a)(1)–(3).

The parties requested executed control agreements in discovery. (Landy Direct ¶ 40.) The Defendants offered evidence of control agreements for certain accounts (the "Controlled Accounts"). (*See* DX AIU; DX AIV; DX AIW; DX AIX; DX AIY; DX AIZ.) Given the control agreements, the JSNs have established control over those accounts. Additionally, the Plaintiffs concede that certain accounts the Committee initially challenged are controlled by Wells Fargo, which is the Third Priority Collateral Agent. Since Wells Fargo controls those accounts and is the secured party for the Junior Secured Notes, the JSNs have sufficiently established control over the WF Accounts. The Court finds that the Controlled Accounts and the WF Accounts are the only Deposit Accounts over which the JSNs have established control.

The JSNs claim to have liens on certain Ally Bank accounts by virtue of Ally's corporate relationship with AFI, the Revolver Lender. But Ally and AFI are not the same entity. The JSNs cannot establish control over Ally Bank accounts due to the corporate relationship between Ally and AFI. And even if AFI had control over those accounts by virtue of its relationship with Ally Bank, that would not benefit the JSNs.

Under the U.C.C., the Notes Trustee has the burden of tracing funds to "identifiable cash proceeds" of collateral that would be automatically perfected under U.C.C. § 9–514(c). U.C.C. § 9–315. *See also In re Milton Abeles, LLC,* No. 812–70158–reg, 2013 WL 530414 at *2 (Bankr.E.D.N.Y. Sept. 20, 2013) ("[S]ection 9–315 ***617** provides that 'proceeds' of a secured creditor's collateral must be 'identifiable proceeds.' Proceeds that are commingled with other property are 'identifiable' only if 'the secured party identifies the proceeds by a method of tracing.' "); *Matter of Guaranteed Muffler Supply Co., Inc.,* 1 B.R. 324, 330 (Bankr.N.D.Ga.1979) ("secured parties bear the burden of identifying, or tracing, the proceeds obtained upon the sale of property in which they have an interest ..."). But for a single account that the Plaintiffs concede contains proceeds of JSN Collateral, the Defendants have failed to provide sufficient evidence that any deposit accounts contain proceeds of JSN Collateral.

After excluding the Controlled Assets, the WF Accounts, and the proceeds account, the amount of funds in the remaining deposit accounts (i.e., the Avoidable Deposit Accounts) as of the Petition Date was $48,439,532. Accordingly, the JSNs do not have a lien on the Avoidable Deposit Accounts pursuant to sections 544(a)(1)–(2) of the Bankruptcy Code. The property or the

value of the property represented by the Avoidable Deposit Accounts should be recovered and/or preserved for the benefit of the Debtors' estates pursuant to sections 550(a) and 551 of the Bankruptcy Code.

For the foregoing reasons, the Court finds that the value of the JSNs' collateral should be reduced by $48,439,532, the amount of cash in the Avoidable Deposit Accounts as of the Petition Date.

c. The JSNs Do Not Have a Lien on the Unencumbered Real Property.

[25] **[26]** To perfect a lien on real property, a secured party must execute a mortgage or a deed of trust and duly record it against the title of such real property. *SeeIn re Churchill Mortg. Inv. Corp.*, 233 B.R. 61, 70 (Bankr.S.D.N.Y.1999) ("Under the New York Real Property Law § 291, a security interest in real property can be perfected only by filing written notice with the Clerk of the County where the property is located so that the lien may be publicly recorded, giving notice of the encumbrance to potential purchasers or future creditors."). The Court finds that the JSNs do not have a perfected security interest in or lien on any of the Unencumbered Real Property because that property was not subject to an executed and filed mortgage or deed of trust. Accordingly, any JSN lien with respect to the Unencumbered Real Property is avoidable pursuant to sections 544(a)(1) and (2) of the Bankruptcy Code, and the property or the value of the property represented by the Unencumbered Real Property should be recovered and/or preserved for the benefit of the Debtors' estates pursuant to sections 550(a) and 551 of the Bankruptcy Code.

For the foregoing reasons, the Court finds that the value of the JSNs' collateral should be reduced by $21 million, the fair market value of the Unencumbered Real Property as of the Petition Date.

7. The Plaintiffs Failed to Establish Preferential Transfers to the JSNs.

The Plaintiffs seek to avoid $270 million of the JSNs' claim as preferential transfers (the "Alleged Preferential Transfers"). The Alleged Preferential Transfers, listed on Schedule 6 to the Committee's complaint (PX 127), consist of (1) mortgage loan instruments, including HFS Loans and FHA/VA loans, (2) REO property, and (3) government insurance claims arising as a result of expenditures incurred by the Debtors in connection with FHA/VA ***618** Loans.[48] The Plaintiffs contend that these assets first became JSN Collateral on or after February 29, 2012, during the Modified Preference Period.[49] To prove this contention, the Plaintiffs point to how the collateral was recorded in the CFDR as of February 29, 2012, and as of the Petition Date. As such, the Plaintiffs claim to have met their prima facie burden of proof for a preference claim under Bankruptcy Code sections 547(b)(1)-(5).

48 The "Adjusted Preference Assets" asserted by the Plaintiffs do NOT include the following assets identified on Schedule 6 of the Committee Action: (1) 18 loans identified as "HFS Revolver" or "HFS Blanket," with a net book value of $1,950,188.00, (2) two REO properties identified as "HFS Blanket," with a net book value of $50,478.00, (3) three mortgage loans that were refinanced (the "Refinanced Mortgages"), with a net book value of $1,021,096.00, and (4) certain REO properties that Mr. Landy acknowledges were "never transferred to or for the benefit of the [Noteholders] during the preference period," with a net book value of $12,106,073.00. (Landy ¶ 57; DX ABN at 12; DX AIS at 4; PX 127.)

49 The Committee used a reduced preference period from February 29, 2012 through the Petition Date (75 days instead of 90) (the "Modified Preference Period"). (ECF Doc. # 97.)

The Defendants offer two reasons why the Plaintiffs are not entitled to avoid the Alleged Preferential Transfers: (1) the Plaintiffs failed to make a prima facie case for avoidance, and (2) even if the Plaintiffs could make such a showing, their Preference Claim is barred by the "improvement in position test." Because the Court concludes that the Plaintiffs have failed to make a prima facie case for avoidance of the Alleged Preferential Transfers the Court need not consider the "improvement in position test."

[27] Section 547(b) of the Bankruptcy Code "permits a trustee to avoid certain prepetition transfers as 'preferences.' "[50] 5 COLLIER ON BANKRUPTCY ¶ 547.01. Section 547(b) lays out the elements of an avoidable preference as a transfer of an interest in debtor property:

> (1) to or for the benefit of a creditor;
>
> (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
>
> (3) made while the debtor was insolvent;
>
> (4) made—
>
> (A) on or within 90 days before the date of the filing of the petition; or
>
> (B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and
>
> (5) that enables such creditor to received more than such creditor would receive if—
>
> (A) the case were a case under chapter 7 of this title;
>
> (B) the transfer had not been made; and
>
> (C) such creditor received payment of such debt to the extent provided by the provisions of this title.

11 U.S.C. § 547(b). Unless the trustee proves each and every one of these elements, a transfer is not avoidable as a preference under section 547(b). *See*11 U.S.C. § 547(g) ("For the purposes of this section, the trustee has the burden of proving the avoidability of a transfer under subsection (b) of this section ...."); *see also Waldschmidt v. Ranier (In re Fulghum Constr. Corp.),* 706 F.2d 171, 172 (6th Cir.1983) ("As is facially evident from this provision, all five enumerated criteria must ***619** be satisfied before a trustee may avoid any transfer of property as a preference.").

50 A preconfirmation debtor-in-possession has the power to initiate and prosecute preference actions. *See*11 U.S.C. § 1107.

a. The Plaintiffs Failed to Show that the JSNs Were Undersecured as of February 29, 2012.

[28] The Defendants argue that the Plaintiffs failed to make a showing that the JSNs were undersecured at the start of the Modified Preference Period, immunizing them "from [a] preference attack because [they] would have been paid in full in a hypothetical Chapter 7 liquidation by virtue of [their] realization on [their] collateral." *Official Comm. v. AAF–McQuay (In re 360networks(USA), Inc.),* 327 B.R. 187, 190 (Bankr.S.D.N.Y.2005); *see also In re Santoro Excavating, Inc.,* 32 B.R. 947, 948 (Bankr.S.D.N.Y.1983) ("[A] payment [during the preference period] to a creditor with an allowed fully secured claim is not a preference.") (collecting cases). Where a creditor asserts that it was oversecured at the time of the alleged preferential transfer, it is the plaintiff's burden to refute that assertion. *See Savage & Assocs., P.C. v. Cnty. of Fairfax (In re Teligent, Inc.),* No. 01–12974(SMB), 2006 WL 1030417 at *3 (Bankr.S.D.N.Y. Apr. 13, 2006) ("Teligent II") ("[W]here the defendant in a preference action asserts that it was oversecured, the plaintiff must prove a negative, to wit that the defendant was not oversecured."), *aff'd sub nom In re Teligent Servs. Inc.,* No. 06 Civ. 03721(KMW), 2009 WL 2152320 (S.D.N.Y. July 17, 2009) ("*Teligent III* "). A defendant's assertion that it was fully secured is not a defense pursuant to section 547(c), but "rather a negation of one of the elements of a preference action, pursuant to section 547(b)." *Teligent III,* 2009 WL 2152320, at *6.

[29] Throughout this case, the Defendants have maintained that they were oversecured as of the start of the Modified Preference Period, placing the burden squarely on the Plaintiffs to prove that the Defendants were not oversecured. While the Plaintiffs' expert Mr. Puntus provided a proposed valuation of the JSNs' collateral as of the Petition Date,[51] he did not calculate the

value as of the start of the Modified Preference Period. In fact, none of the Plaintiffs' experts provided a valuation of the JSN Collateral at the beginning of the Modified Preference Period, or at any time during that period. As a result, the Plaintiffs have failed to satisfy section 547(b)(5) and are not entitled to avoid the portion of the Defendants' liens related to the so-called "Preferential Transfers."

51 The Court reiterates comments made during closing arguments that it has serious problems with the methodology employed by Mr. Puntus in his valuation.

b. The Plaintiffs Failed to Prove the Identity or Scope of Transfers of Collateral to Defendants During the Modified Preference Period.

Even assuming that the Plaintiffs had shown that the Defendants were undersecured at the beginning of the Modified Preference Period, the Plaintiffs have failed to show the identity or scope of these Alleged Preferential Transfers. The Plaintiffs' only evidence in support of their preference claim, the CFDR, is reliable as a business record to establish when AFI LOC Collateral was properly released, but it is not sufficient to establish the identity or scope of the Alleged Preferential Transfers. The Plaintiffs' expert Mr. Landy identified the Alleged Preferential Transfers by performing a comparison of CFDR extracts as of February 29, 2012, and the Petition Date. (Oct. 17 Tr. 152:16–153:13, 162:12–15.) He concluded that any asset appearing in the CFDR for the first time as JSN Collateral during the Modified ***620** Preference Period was a preferential transfer, though he "did not attempt to understand the circumstances for why each loan may have appeared on 5/13...." (Oct. 17 Tr. 153:10–22; 155:5–7.) Indeed, the CFDR contains little information explaining why an asset would appear for the first time or reappear after an absence in the database. (*See* PX 139.) At trial, the Defendants raised a variety of explanations why these assets may have appeared in the CFDR during the Modified Preference Period, tending to negate their status as preferential transfers. For example, the loans may have been modified, repaid in full and then subsequently drawn upon, or they may represent refinancings of old loans that formerly constituted JSN Collateral. (Oct. 22 Tr. 26:23–27:9, 28:3–10, 31:18–32:15, 33:18–34:4, 35:18–21, 42:14–43:3, 56:25.) Under any example, they would not be preferential transfers.

The Defendants' expert Mr. Winn specifically identified a variety of alleged "Preferential Transfers" that should not have been included in Schedule 6. (DX ABN 12 ("[T]he CFDR shows that approximately $18 million of the alleged Preference Assets were owned by the Debtors and served as JSN Collateral as of or prior to 2/29/12 and thus should not be listed as Preference Assets.").) Mr. Landy, who prepared Schedule 6, conceded that certain of these assets were inaccurately included on Schedule 6. (*See* Landy Direct ¶ 56 ("I have determined that I concur with Mr. Winn's observations regarding (a) 18 loans identified as 'FHA/VA Reclassified as Loans HFS' ... with a net book value of approximately $1.95 million, and (b) 2 loans identified as 'REO Reclassified as Loans' ..., with a net book value of $50,478.") ("Mr. Winn identifies approximately $12 million of 'REO' assets that were pre-existing components of the JSN Collateral pool as of February 29, 2012, and were therefore never transferred to or for the benefit of the JSNs during the preference period.").) Specifically, Mr. Landy concurred with Mr. Winn's conclusions that the following do not constitute preferential transfers:

- The FHA/VA assets for which no Loan Funding Date exists within the CFDR and for which the Debtors have provided no information nor conducted any inquiry whether such assets are refinancings (despite the acknowledgment that such assets could be refinancings);

- The approximately $12 million of REO assets which the Committee's expert Marc E. Landy concedes were within the CFDR in the JSN Collateral before the Modified Preference Period. The Committee seeks to avoid these assets "to the extent ... ownership of these REO properties was transferred ... to an REO special purpose vehicle during the preference period," yet offered no evidence that such transfers to special purpose vehicles occurred during the Modified Preference Period;

- The HFS loans appearing for the first time in the CFDR during the Modified Preference Period with Loan Funding Dates before the Modified Preference Period, for which neither the Committee nor the Debtors can offer a reasonable and

consistent explanation, the majority of which have "Loan Modification Dates" and a portion of which are coded as HELOCs (suggesting that their appearance is the result of loan modifications or draws on HELOCs); and

- The HFS and FHA/VA loans that appeared in the CFDR before the Modified Preference Period, disappeared from the CFDR and reappeared within the CFDR during the Modified Preference Period.

Given these errors, appearance in the CFDR alone cannot be enough to identify ***621** a preferential transfer. Too many questions and inconsistencies remain to conclude that the JSNs first acquired an interest in these assets during the Modified Preference Period. Thus, the Plaintiffs have failed to prove the identity and scope of the Alleged Preferential Transfers and are not entitled to avoid this portion of the JSNs' claim.

8. The Plaintiffs Are Not Entitled to Charge the JSNs with a $143 Million Carve Out Payment If the Plaintiffs Can Pay Professional Fees and Administrative Expenses with Unencumbered Cash.

The Plaintiffs seek a declaration permitting them to charge up to an additional $143 million in Carve Out expenses, thereby further reducing the JSNs' secured claim on the Effective Date. The Court holds that the Plaintiffs are not entitled to this declaration if they can pay fees and expenses with unencumbered cash. While this case is not over, it appears that the Debtors have substantial unencumbered cash available to pay administrative expenses.

[30] A carve out is a provision of a cash collateral order that allows for some expenditure of administrative and/or professional fees to be paid before a secured creditor gets paid on its collateral. *See In re Blackwood Associates, L.P.,* 153 F.3d 61, 68 (2d Cir.1998) (stating that "absent an agreement to the contrary, a secured creditor's collateral may only be charged for administrative expenses, including attorney's fees, to the extent these expenses directly benefited that secured creditor," but "if a secured party consents to allowing such administrative expenses, that party may be liable for such expenses even in the absence of conferred benefit"); 3 COLLIER ON BANKRUPTCY ¶ 364.04[2][d] ("A carve-out gives the benefitted claimants a priority in the postpetition lender's collateral ahead of the lender's priority and, if the carve-out is for the benefit of only certain named administrative claimants, above other administrative claimants as well."); Richard B. Levin, *Almost All You Ever Wanted to Know About Carve Out,* 76 AM. BANKR. L.J. 445, 445 (2002) ("As generally used, a carve out is an agreement between a secured lender, on the one hand, and the trustee or debtor in possession ... on the other, providing that a portion of the secured creditor's collateral may be used to pay administrative expenses.").

[31] The Bankruptcy Code does not deal with carve out provisions typically included in cash collateral orders. *See In re White Glove, Inc.,* No. 98–12493 DWS, 1998 WL 731611 at *6 (Bankr.E.D.Pa. Oct. 14, 1998) ("The term 'carve out' is one of those uniquely bankruptcy phrases, much like 'cram down,' that appears nowhere in the bankruptcy statute but connotes definite meaning to the parties."); *see also* Levin at 445 ("Unlike 'cram down,' ... which has a relatively well-defined meaning derived from ¶ 1129(b) of the Bankruptcy Code, 'carve out' does not derive its substance from any particular section of the Bankruptcy Code."). Unless it conflicts with provisions of the Bankruptcy Code, a carve out is construed applying normal contract interpretation provisions. *See Blackwood,* 153 F.3d at 67 (applying "the statutory context underlying cash collateral stipulations[ ] and the text of the Stipulation itself" to conclude that a disputed carve out provision did not grant the chapter 11 debtor's counsel payment from cash collateral when the debtor failed to meet the terms of the cash collateral stipulation).

[32] The usual purpose of a carve out is to assure the payment of specified administrative expenses from a secured creditor's ***622** collateral in the event that the case goes badly, use of cash collateral is terminated, and sufficient unencumbered funds are no longer available to administer the case, usually after conversion to chapter 7. *See* Levin at 451 ("The carve out becomes important to the protected administrative claimants *only* when the unencumbered assets in the bankruptcy estate that remain after application of the collateral proceeds to the secured claim are not adequate to pay all administrative claims, so that the administrative claimants will need to look to the carve out as an alternative source for payment.") (emphasis added).

[33] Here, the Cash Collateral Order controls the priority of the JSN liens with respect to the Carve Out. The Final Cash Collateral Order creates a Carve Out from the JSNs' cash collateral that subjects and subordinates the JSN liens to the Carve Out amount but does not otherwise affect the validity of the JSN liens on carved out JSN cash collateral:

> the [JSN Liens] are valid, binding, perfected, and enforceable first priority liens on and security interests in the personal and real property constituting "Collateral" under, and as defined in, the Junior Secured Notes Documents ... and (iii) are subject and subordinate only to (A) the liens and security interests granted to the AFI Lender under the AFI Revolver, all subject to the terms and conditions of the Intercreditor Agreement, dated as of June 6, 2008 ..., (B) the Carve Out, and (C) the liens and security interests granted to secure the Adequate Protection Obligations....

(PX 76 at 11–12.) The Carve Out, in turn, is defined as the sum of: (1) court and United States Trustee fees, (2) accrued and unpaid professional fees following a termination event in an aggregate amount not exceeding $25 million (plus all unpaid professional fees allowed by the Court at any time that were incurred on or before the business day following the Carve Out Notice), and (3) unpaid professional fees that were allowed prior to the termination event; provided that,

> (A) the Carve Out shall not be available to pay any such Professional Fees incurred in connection with the initiation or prosecution of any claims, causes of action, adversary proceedings or other litigation against the Adequate Protection Parties, (B) so long as no event of default shall have occurred and be continuing, the Carve Out shall not be reduced by the payment of fees and expenses allowed by the Court and payable under sections 328, 330 and 331 of the Bankruptcy Code, and (C) nothing in this Final Order shall impair the right of any party to object to any such fees or expenses to be paid by the Debtors' estates.

(*Id*. at 31–32.)

The Cash Collateral Order clearly requires the JSNs to subordinate their secured claim to the payment of the Carve Out, but is silent whether the Debtors may use those funds, further reducing the JSNs' secured claim, when other unencumbered funds are available. Absent contractual language requiring that result, the Court concludes that the Cash Collateral Order does not go beyond the ordinary purpose of assuring funds to pay the specified expenses if unencumbered funds are no longer available to do so.

The JSNs' liens remain subordinated to the Carve Out. If during the remainder of the case, unencumbered funds are no longer available to pay the expenses, the JSN Collateral can be used for that purpose. At this stage, however, there is no reason to believe that will occur. The Court holds that the JSNs' Collateral should not be reduced at this time.

***623 E. Given the Court's Findings on What Constitutes JSN Collateral, the JSNs are Undersecured.**

Notwithstanding the JSNs' ability to aggregate their collateral across debtors, the Court finds that, as of the conclusion of Phase I, the JSNs are undersecured and not entitled to postpetition interest and fees.[52] As of the Petition Date, the JSNs held secured claims against ResCap, and certain of its affiliates as guarantors and grantors, in the face amount of $2.222 billion, consisting of $2.120 billion in unpaid principal as of the Petition Date, and $101 million in unpaid prepetition interest. (DX ABF at 3.) As the Court discussed in section III.A above, the JSNs' claim will not be reduced by unamortized OID. Assuming an effective date of December 15, 2013, the JSNs will assert a claim for postpetition interest at the default rate, in the amount of $342 million. (JSN Corrected Proposed Findings of Fact, ECF Doc. # 190 § II ¶ 15.) The JSNs are only entitled to receive postpetition interest up to the value of their collateral. 11 U.S.C. § 506(b). Thus, to receive their full claim for postpetition interest, the JSNs have to establish an effective date value of their collateral of at least $2.564 billion. At this point in the case, they fall well shy of the mark.

52 This finding is not a final decision whether the JSNs are oversecured or undersecured. Issues relating to certain other alleged JSN collateral were reserved for Phase II of the trial.

The parties have largely agreed on $1.888 billion as a baseline estimation of the Effective Date value of the JSN Collateral. (DX AIR at 5.) The Plaintiffs seek to subtract from the baseline; the Defendants seek to add to it. Based on the Court's rulings, the following amounts will be added to the baseline:

- $40 million in equity held at certain non-Debtors;
- $17 million for a net increase in the value of the FHA/VA Loans;
- $18.395 million for software; and
- $10 million for tradename, iconography, and logotype.

The following amounts will be subtracted from the baseline:

- $48,439,532 in Deposit Accounts (the JSNs retain an interest in $63,297); and
- $20.8 million of unencumbered real property.

Based on the Court's ruling, the following factors will not affect the baseline valuation:

- The Plaintiffs may not charge an additional $143 million of expenses to the JSNs' collateral under the cash collateral carve out at this time.
- The Plaintiffs have not carried their burden in proving any preferential transfers.
- The JSNs do not have a lien on the $1.1 billion of AFI LOC Collateral.
- The JSNs have a lien on $24 million of Former Bilateral Facilities Collateral.
- The JSNs have a lien on $10 million of Reacquired Mortgage Loans.
- The JSNs are not entitled to a $66 million allocation from sale proceeds for net increases in HFS Collateral.
- The JSNs do not have a lien on any other intangibles or goodwill.

Based on the above findings, the JSNs have established that the Effective Date value of their collateral is $1,904,155,468. Because their claim is for the face amount of $2.222 billion, the JSNs are undersecured at the end of Phase I. A final determination of the extent of their security will ***624** be deferred until after Phase II of the trial.

IV. *CONCLUSION*

The Phase I trial presented a large number of complex factual and legal issues requiring extraordinary time and expense for the parties and considerable effort for the Court to reach a result leaving the JSNs substantially undersecured. The JSNs have achieved that result in a case in which the proposed plan would pay the JSNs *all* prepetition principal and interest. The JSNs have pursued from the start a strategy where they contest everything and concede nothing (even when the Court has questioned whether they are acting in good faith). The JSNs have made clear that they will continue to follow the same strategy in the Phase II trial and contested confirmation hearing beginning on November 19, 2013.

The Court will continue to decide all issues fairly (the JSNs did prevail on some of the important issues in the Phase I trial), but it should not be lost on anyone that the JSNs stand virtually alone in this case in failing to reach a consensual agreement to resolve their issues. The result has been protracted proceedings that have burdened the estate and reduced funds available to satisfy creditor claims. That is unfortunate!

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961 F.2d 378
United States Court of Appeals,
Second Circuit.

In re CHATEAUGAY CORPORATION; Reomar, Inc.; and LTV Corporation, Debtors.
The LTV CORPORATION, Plaintiff-Appellee,
The Official Committee of Unsecured Creditors of LTV Steel Company, Inc., Intervenor-Appellee,
v.
VALLEY FIDELITY BANK & TRUST COMPANY, as Trustee, Defendant-Appellant,
The New Connecticut Bank and Trust Company, N.A.; The Connecticut National Bank; Huntington National Bank; IBJ Schroder Bank & Trust Company; Maryland National Bank; and Team Bank, N.A., Intervenors-Appellants.

No. 727, Docket 91-5098. | Argued Jan. 6, 1992. | Decided April 10, 1992.

Chapter 11 debtor sought order disallowing unamortized original issue discount (OID) on claims filed by indenture trustee for debenture holders and note holders. The United States Bankruptcy Court for the Southern District of New York, 109 B.R. 51, Burton R. Lifland, Chief Judge, granted in part debtor's motion for partial summary judgment, and indenture trustee appealed. The United States District Court for the Southern District of New York, 130 B.R. 403, Shirley Wohl Kram, J., affirmed, and appeal was taken. The Court of Appeals, Oakes, Chief Judge, held that: (1) claim for OID on debentures issued prepetition by debtor had to be disallowed, to the extent that it was unamortized when the Chapter 11 petition was filed; (2) new notes issued to debenture holders prepetition in face value debt-for-debt exchange offer as part of consensual workout did not create any new OID, for purposes of statute precluding claims for unamortized OID; and (3) proper method for calculating OID amortization was the constant interest method, rather than the straight line method.

District Court judgment affirmed in part and reversed in part, and matter remanded.

See also 111 B.R. 67.

West Headnotes (3)

[1] **Bankruptcy** Interest

Claim for original issue discount (OID) on debentures issued prepetition by Chapter 11 debtor had to be disallowed as unmatured interest, to the extent that the OID was unamortized when the Chapter 11 petition was filed. Bankr.Code, 11 U.S.C.A. § 502(b)(2).

22 Cases that cite this headnote

[2] **Bankruptcy** Interest

New notes issued to debenture holders prepetition in face value debt-for-debt exchange offer as part of consensual workout did not create any new original issue discount (OID), for purposes of statute which precludes claims for unamortized OID; rather, the OID on the new debt equaled the discount carried over from the old debt. Bankr.Code, 11 U.S.C.A. § 502(b)(2).

12 Cases that cite this headnote

[3] **Interest** Mode of Computation in General

Proper method for calculating original issue discount (OID) amortization, for purposes of statute which precludes claims for unamortized OID, was the constant interest method, which calculates OID amortization on the assumption that interest is compounded over time, rather than the straight line method, which spreads the discount amount equally over the duration of the maturation of the note. Bankr.Code, 11 U.S.C.A. § 502(b)(2).

7 Cases that cite this headnote

Attorneys and Law Firms

***379** John A. Walker, Jr., Knoxville, Tenn., (Walker & Walker, of counsel), for defendant-appellant.

James J. Tancredi, Katherine Burroughs, Day, Berry & Howard, Hartford, Conn., of counsel, for intervenor-appellant The New Connecticut Bank and Trust Co., N.A.

Alan E. Lieberman, Ira H. Goldman, Deborah S. Frisone, Shipman & Goodwin, Hartford, Conn., of counsel, for intervenor-appellant The Connecticut National Bank.

Lawrence E. Oscar, Hahn Loeser & Parks, Cleveland, Ohio, of counsel, for intervenor-appellant Huntington National Bank.

Paul L. Bindler, Shalom Jacob, Rosenman & Colin, New York City, of counsel, for intervenor-appellant IBJ Schroder Bank & Trust Co.

Brooke Schumm III, Baltimore, Md. (Semmes, Bowen & Semmes, of counsel), for intervenor-appellant Maryland National Bank.

Judith W. Ross, Thompson & Knight, Dallas, Tex., of counsel, for intervenor-appellant Team Bank, N.A.

Karen E. Wagner, New York City (Maryellen Abely, Davis Polk & Wardwell; Arlene R. Alves, Kaye, Scholer, Fierman, Hays & Handler, of counsel), for plaintiff-appellee.

Lisa Rosenthal, New York City (Mark A. Speiser, Stroock & Stroock & Lavan, of counsel), for intervenor-appellee The Official Committee of Unsecured Creditors of LTV Steel Co., Inc.

Before OAKES, Chief Judge, PRATT and MINER, Circuit Judges.

Opinion

OAKES, Chief Judge:

Valley Fidelity Bank & Trust Co. ("Valley") and intervenors appeal from a judgment of the United States District Court for the Southern District of New York, Shirley Wohl Kram, *Judge,* affirming a judgment of the United States Bankruptcy Court for the Southern District of New York, Burton R. Lifland, *Chief Judge*. The bankruptcy court granted partial summary judgment in favor of the debtor, the LTV Corporation ("LTV"), disallowing Valley's claims to the extent they included unamortized original issue discount ("OID"). On this appeal, Valley argues that the bankruptcy court and district court erred by holding (1) that new OID arose on an exchange of debt securities performed as part of LTV's failed attempt to avoid bankruptcy through a consensual workout, and (2) that amortization of OID should be calculated by the constant interest method, rather than by the straight line method. For the reasons set forth below, we reverse in part and affirm in part. We hold first that while claims must be disallowed to the extent of unamortized OID, no new OID arose on LTV's debt-for-debt exchange, and second, that OID amortization should be calculated by the constant interest method.

FACTS

In July 1986, LTV, a steel company that makes defense and industrial products, filed for Chapter 11 reorganization along with sixty-six of its subsidiaries. LTV filed objections in September 1989 to two proofs of claim, numbers 20,069 and 20,067, filed in November 1987 by Valley on behalf of the holders of two securities, the "Old Debentures" and the "New Notes." Valley is the trustee for both the Old Debentures and the New Notes.

The Old Debentures are 13 #% Sinking Fund Debentures due December 1, 2002, of which LTV had by December 1, 1982 issued a total face amount of $150,000,000. Of that face amount, $125,000,000 had been issued to the public, for which LTV received ***380** $110,835,000 in cash. The remaining $25,000,000 had been issued to subsidiary pension funds, in lieu of cash contributions of $22,167,000. The proceeds received for the Old Debentures thus amounted to 88.67% of their face value.

The New Notes are LTV 15% Senior Notes due January 15, 2000. In May 1986, LTV offered to exchange $1,000 face amount of New Notes and 15 shares of LTV common stock for each $1,000 face amount of Old Debentures. As of June 1, 1986, $116,035,000 face amount of Old Debentures had been exchanged for the same face amount of New Notes and LTV Common Stock.

In its proofs of claim, Valley did not deduct any amount for unamortized OID. LTV objected to the claims and moved for partial summary judgment, seeking an order disallowing unamortized OID. LTV argued that unamortized OID is unmatured interest which is not allowable by virtue of section 502(b)(2) of the Bankruptcy Code, 11 U.S.C. § 502(b)(2) (1988), and that therefore the claims must be reduced by the amount of unamortized OID. A number of other creditors intervened to address questions of law that they believe may affect their own claims against LTV.

The bankruptcy court granted partial summary judgment for LTV. *In re Chateaugay Corp.,* 109 B.R. 51, 58 (Bankr.S.D.N.Y.1990). The court held that unamortized OID is not allowable under section 502(b)(2), and that the proper method for calculating unamortized OID is the constant interest method. *Id.* The court also held that as indenture trustee, Valley was the proper party in interest to receive notice of LTV's objections. *Id.* Concluding that the amount of unamortized OID on the Old Debentures could be calculated using uncontroverted evidence, but that the amount on the New Notes could not be calculated until a disputed fact-the fair market value of the Old Debentures at the time of the exchange-was resolved, the court granted LTV's motion except as to the amount of unamortized OID on the New Notes. *Id.*

LTV and Valley thereafter stipulated to $3,554,609 and $8,174,134 as the amount of unamortized OID on the Old Debentures and the New Notes, respectively, calculated in accordance with the bankruptcy court's opinion. After that stipulation, Judge Lifland on March 27, 1990 entered a judgment partially disallowing, in the above amounts, Valley's proofs of claim. The district court affirmed the bankruptcy court's decision in its entirety. *In re Chateaugay Corp.,* 130 B.R. 403, 405 (S.D.N.Y.1991).

DISCUSSION

I. *Original Issue Discount and Section 502(b)(2)*

A

Original issue discount results when a bond is issued for less than its face value. The discount, which compensates for a stated interest rate that the market deems too low, equals the difference between a bond's face amount (stated principal amount) and the proceeds, prior to issuance expenses, received by the issuer. OID is amortized, for accounting and tax purposes, over the life of the bond, with the face value generally paid back to the bondholders on the maturity date. If the debtor meets with financial

trouble and turns to the bankruptcy court for protection, as in the present case, then OID comes into play as one of the factors determining the amount of the bondholder's allowable claim in bankruptcy.

[1] Section 502 of the Bankruptcy Code, the framework for Chapter 11 claim allowance, provides that a claim shall be allowed "except to the extent that ... such claim is for unmatured interest." 11 U.S.C. § 502(b)(2) (1988). The first question we face is whether unamortized OID is "unmatured interest" within the meaning of section 502(b)(2). We conclude that it is. As a matter of economic definition, OID constitutes interest. *United States v. Midland-Ross Corp.,* 381 U.S. 54, 57, 85 S.Ct. 1308, 1310, 14 L.Ed.2d 214 (1965) (treating OID for tax purposes as income, not capital); *see also* Frank J. Slagle, Accounting for Interest: An Analysis of Original Issue ***381** Discount in the Sale of Property, 32 S.D.L.Rev. 1, 21 n. 108 (1987) ("The amount of the discount represents compensation to the Lender for the use and forbearance of money, i.e., interest."). Moreover, the Bankruptcy Code's legislative history makes inescapable the conclusion that OID is interest within the meaning of section 502(b)(2). The House committee report on that section explains:

> Interest disallowed under this paragraph includes postpetition interest that is not yet due and payable, and any portion of prepaid interest that represents an original discounting of the claim, yet that would not have been earned on the date of bankruptcy. For example, a claim on a $1,000 note issued the day before bankruptcy would only be allowed to the extent of the cash actually advanced. If the original issue discount was 10% so that the cash advanced was only $900, then notwithstanding the face amount of [the] note, only $900 would be allowed. If $900 was advanced under the note some time before bankruptcy, the interest component of the note would have to be pro-rated and disallowed to the extent it was for interest after the commencement of the case.

H.Rep. No. 595, 95th Cong., 1st Sess. 352-53 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5963, 6308-09.

The courts that have considered the issue under section 502(b)(2) have held that unamortized OID is unmatured interest and therefore unallowable as part of a bankruptcy claim. *In re Public Service Co. of New Hampshire,* 114 B.R. 800, 803 (Bankr.D.N.H.1990); *In re Allegheny Int'l, Inc.,* 100 B.R. 247, 250 (Bankr.W.D.Pa.1989); *see also In re Pengo Indus., Inc.,* 129 B.R. 104, 108 (N.D.Tex.1991). *But cf. In re Radio-Keith-Orpheum Corp.,* 106 F.2d 22, 27 (2d Cir.1939) (under Bankruptcy Act, allowing debentures issued at a discount for full face amount), *cert. denied,* 308 U.S. 622, 60 S.Ct. 380, 84 L.Ed. 520 (1940). The *Public Service* court stated it plainly: "The word 'interest' in the statute is clearly sufficient to encompass the OID variation in the method of providing for and collecting what in economic fact is interest to be paid to compensate for the delay and risk involved in the ultimate repayment of monies loaned." 114 B.R. at 803.

Applying this reasoning to the case at hand, we conclude, as did the bankruptcy and district courts, that OID on the Old Debentures, to the extent it was unamortized when the bankruptcy petition was filed, should be disallowed. We now turn to the main issue in dispute: the applicability of section 502(b)(2) to the New Notes, which were issued in a debt-for-debt exchange offer as part of a consensual workout.

B

[2] A debtor in financial trouble may seek to avoid bankruptcy through a consensual out-of-court workout. Such a recapitalization, when it involves publicly traded debt, often takes the form of a debt-for-debt exchange, whereby bondholders exchange their old bonds for new bonds. The debtor hopes that the exchange, by changing the terms of the debt, will enable the debtor to avoid default. The bondholders hope that by increasing the likelihood of payment on their bonds, the exchange will benefit them as well. The debtor and its creditors share an interest in achieving a successful restructuring of the debtor's financial obligations in order to avoid the uncertainties and daunting transaction costs of bankruptcy.

An exchange offer made by a financially troubled company can be either a "fair market value exchange" or a "face value exchange." *See* Marc S. Kirschner, et al., Prepackaged Bankruptcy Plans: The Deleveraging Tool of the '90s in the Wake of OID

and Tax Concerns, 21 Seton Hall L.Rev. 643, 645-47 (1991); Allen L. Weingarten, Consensual Non-Bankruptcy Restructuring of Public Debt Securities, 23 Rev. of Sec. & Commodities Reg. 159, 161 (1990). In a fair market value exchange, an existing debt instrument is exchanged for a new one with a reduced principal amount, determined by the market value at which the existing instrument is trading. By offering a fair market value exchange, ***382** an issuer seeks to reduce its overall debt obligations. Usually, this is sought only by companies in severe financial distress. A face value exchange, by contrast, involves the substitution of new indebtedness for an existing debenture, modifying terms or conditions but not reducing the principal amount of the debt. A relatively healthy company faced with liquidity problems may offer a face value exchange to obtain short-term relief while remaining fully liable for the original funds borrowed.

The question is whether a face value exchange generates new OID. The bankruptcy court, in an opinion endorsed by the district court, held that it does. The court reasoned that, by definition, OID arises whenever a bond is issued for less than its face amount, and that in LTV's debt-for-debt exchange, the issue price of the New Notes was the fair market value of the Old Debentures. The court therefore concluded that the New Notes were issued at a discount equaling the difference between their face value and the fair market value of the Old Debentures. *In re Chateaugay Corp.,* 109 B.R. at 56-57.

The bankruptcy court's reasoning leaves us unpersuaded. While its application of the definition of OID to exchange offers may seem irrefutable at first glance, we believe the bankruptcy court's logic ignores the importance of context, and does not make sense if one takes into account the strong bankruptcy policy in favor of the speedy, inexpensive, negotiated resolution of disputes, that is an out-of-court or common law composition. *See* H.R.Rep. No. 95-595, 95th Cong., 1st Sess. 220 (1977), *reprinted in* 1978 U.S.S.C.A.N. 5963, 6179-80; *see also In re Colonial Ford, Inc.,* 24 B.R. 1014, 1015-17 (Bankr.D.Utah 1982) ("Congress designed the Code, in large measure, to encourage workouts in the first instance, with refuge in bankruptcy as a last resort."). If unamortized OID is unallowable in bankruptcy, and if exchanging debt increases the amount of OID, then creditors will be disinclined to cooperate in a consensual workout that might otherwise have rescued a borrower from the precipice of bankruptcy. We must consider the ramifications of a rule that places a creditor in the position of choosing whether to cooperate with a struggling debtor, when such cooperation might make the creditor's claims in the event of bankruptcy smaller than they would have been had the creditor refused to cooperate. The bankruptcy court's ruling places creditors in just such a position, and unreversed would likely result in fewer out-of-court debt exchanges and more Chapter 11 filings. Just as that ruling creates a disincentive for creditors to cooperate with a troubled debtor, it grants a corresponding windfall both to holdouts who refuse to cooperate and to an issuer that files for bankruptcy subsequent to a debt exchange. *See* John C. Coffee, Jr. & William A. Klein, Bondholder Coercion: The Problem of Constrained Choice in Debt Tender Offers and Recapitalizations, 58 U.Chi.L.Rev. 1207, 1248-49 & n. 121 (1991); Kirschner, et al., supra, 21 Seton Hall L.Rev. at 644-60.

The bankruptcy court's decision might make sense in the context of a fair market value exchange, where the corporation's overall debt obligations are reduced. In a face value exchange such as LTV's, however, it is unsupportable. LTV's liability to the holders of the New Notes was no less than its liability to them had been when they held the Old Debentures. The bankruptcy court, by finding that the exchange created new OID, reduced LTV's liabilities based on an exchange which, because it was a face value exchange, caused no such reduction on LTV's balance sheet.

We hold that a face value exchange of debt obligations in a consensual workout does not, for purposes of section 502(b)(2), generate new OID. Such an exchange does not change the character of the underlying debt, but reaffirms and modifies it. *Cf. In re Red Way Cartage Co.,* 84 B.R. 459, 461 (Bankr.E.D.Mich.1988) (in context of preferential transfers, settlement agreement did not create new debt, but only reaffirmed the antecedent debt); *In re Magic Circle Energy Corp.,* 64 B.R. 269, 273 (Bankr.W.D.Okla.1986) (same, explaining, "We do not accept the proposition that the consolidation of [debt] into a long-term promissory note wrought a metamorphosis ***383** wherein the nature of the debt was altered."); *In re Busman,* 5 B.R. 332, 336 (Bankr.E.D.N.Y.1980) ("the rule [of § 502(b)(2)] is clearly not entrenched as an absolute").

In the absence of unambiguous statutory guidance, we will not attribute to Congress an intent to place a stumbling block in front of debtors seeking to avoid bankruptcy with the cooperation of their creditors. Rather, given Congress's intent to encourage consensual workouts and the obvious desirability of minimizing bankruptcy filings, we conclude that for purposes of section

502(b)(2), no new OID is created in a face value debt-for-debt exchange in the context of a consensual workout. Thus, OID on the new debt consists only of the discount carried over from the old debt, that is, the unamortized OID remaining on the old debt at the time of the exchange.

The cases upon which the bankruptcy court relied in reaching a contrary conclusion are distinguishable. The court found support for its conclusion by looking to tax cases, because under the Internal Revenue Code, for purposes of determining taxable income, an exchange offer generates new OID. *See, e.g., Cities Service Co. v. United States,* 522 F.2d 1281, 1288 (2d Cir.1974) (holding in tax context that OID arose on exchange because the face amount of the issue exceeded the consideration), *cert. denied,* 423 U.S. 827, 96 S.Ct. 43, 46 L.Ed.2d 43 (1975). The tax treatment of a transaction, however, need not determine the bankruptcy treatment. *See, e.g., In re PCH Assocs.,* 55 B.R. 273 (Bankr.S.D.N.Y.1985) (agreement structured as ground lease for tax benefits treated as joint venture under Bankruptcy Code), *aff'd,* 60 B.R. 870 (S.D.N.Y.), *aff'd,* 804 F.2d 193 (2d Cir.1986). The tax treatment of debt-for-debt exchanges derives from the tax laws' focus on realization events, and suggests that an exchange offer may represent a sensible time to tax the parties. The same reasoning simply does not apply in the bankruptcy context. *See* Kirschner, supra, 21 Seton Hall L.Rev. at 655-56.

Similarly distinguishable is *In re Allegheny Int'l, Inc.,* 100 B.R. 247 (Bankr.W.D.Pa.1989), upon which the bankruptcy court relied heavily in determining that new OID was created by LTV's debt exchange. In *Allegheny,* the court considered and rejected the argument "that section 502(b)(2) does not apply ... to debentures created in the context of an exchange offer." *Id.* at 250. That case, however, involved a debt-for-equity exchange, not a debt-for-debt exchange. The debtor in *Allegheny* offered to exchange debt instruments for previously issued preferred stock. *Id.* at 248. Thus, the stockholders had no claim against the debtor prior to the exchange, and the debtor's balance sheet reflected an increase in overall liabilities from the exchange. We need not decide whether *Allegheny* was correct. Whether or not its reasoning is sound in the context of a debt-for-equity exchange, it is inapplicable to a debt-for-debt exchange such as LTV's.

II. ***Calculating OID Amortization***

[3] We now turn to the methodology for calculating OID amortization. Valley argues that the proper method for calculating unamortized OID under the Bankruptcy Code is the straight line method, by which the amount of the discount is spread equally over the duration of the maturation of the note. Under the straight line method, the same amount of interest accrues during each day of the instrument's term. LTV argues, in contrast, that the constant interest method-which also goes by the names yield-to-maturity, effective interest, or economic accrual-should be used. The constant interest method calculates OID amortization on the assumption that interest is compounded over time. Under the constant interest method, the amount of interest that accrues each day increases over time.

The bankruptcy court and district court opted for the constant interest method, and we agree. The constant interest method comports more closely than the straight line method with economic reality. *See* Slagle, supra, 32 S.D.L.Rev. at 24 (criticizing straight line method as a distortion on interest accrual).

***384** One bankruptcy court has held that OID should be calculated by the straight line method for purposes of Bankruptcy Code section 502(b)(2), *Allegheny,* 100 B.R. at 254, but its reasoning is unconvincing. That court simply noted that the legislative history of section 502(b)(2) provides that unmatured interest should be "pro-rated," and assumed without analysis that the pro-rating must be done so that the increases are constant through time, rather than so that the *rate* of increase is constant through time. To say that interest must be pro-rated is only to restate the question, which is what method should be used for that pro-rating.

One further point must be addressed regarding the calculation of OID amortization. Our holding today that, for purposes of section 502(b)(2), no new OID is created by a face value debt-for-debt exchange in a consensual workout, means that the old OID is carried over to the new debt. In other words, when the Old Debentures were exchanged for the New Notes, the New Notes carried a discount equaling the amount of OID remaining on the Old Debentures after amortization by the constant interest method. The amount of OID remaining must then be amortized, again employing the constant interest method, over

the life of the New Notes. Thus, a creditor's claim in bankruptcy may differ depending on whether the creditor participated in a workout; that difference, however, derives not from any new OID created by the exchange, but from the logical necessity of an amortization schedule that concludes on the maturity date. In the present case, because the New Notes carried an earlier maturity date than the Old Debentures, those bondholders who cooperated with the debtor find themselves with a slightly larger claim in bankruptcy, after the disallowance of unamortized OID, than those who did not.

Accordingly, the judgment of the district court is affirmed in part and reversed in part, and the matter remanded to the district court for remand to the bankruptcy court for further proceedings consistent with this opinion.

Parallel Citations

60 USLW 2653, 26 Collier Bankr.Cas.2d 1174, 22 Bankr.Ct.Dec. 1347, Bankr. L. Rep. P 74,550

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UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

In re	:	CHAPTER 11
	:	(Jointly Administered)
NEW CENTURY TRS HOLDINGS, INC., *et al.*	:	Case No. 07-10416 (KJC)
Debtors	:	

MEMORANDUM[1]

BY: KEVIN J. CAREY, UNITED STATES BANKRUPTCY JUDGE

BACKGROUND

New Century TRS Holdings, Inc. and its affiliates (the "Debtors") filed voluntary petitions for relief under chapter 11 of the United States Bankruptcy Code on April 2, 2007.[2] Currently before the Court is the Debtors' motion pursuant to 11 U.S.C. §§105(a) and 362(a) for an order enforcing the automatic stay against the Internal Revenue Service and granting related relief (docket no. 3829)(the "Motion"). In the Motion, the Debtors ask this Court to enter an order directing the Internal Revenue Service (the "IRS") to release a tax refund to the Debtors. The IRS opposes the Motion, arguing that this Court is without jurisdiction to consider it. For the reasons set forth herein, the Motion will be denied.

UNDISPUTED FACTS

The following facts, asserted by the parties in their respective submissions, have not been disputed and I rely upon them in consideration of the Motion.

[1]This Memorandum constitutes the findings of fact and conclusions of law, as required by Fed.R.Bankr.P. 7052.

[2]By Order dated April 3, 2007, the Court granted the motion by New Century TRS Holdings, Inc. and its affiliates for joint administration of the related chapter 11 cases. (*See* Docket no. 52).

New Century Financial Corporation ("NCF") was a large specialty mortgage finance business. Through its subsidiaries and its primary holding company subsidiary, New Century TRS Holdings, Inc., NCF originated, purchased, sold and serviced mortgage loans nationwide.

On July 17, 2007, the Debtors submitted a From 1139 to the IRS in accordance with Section 6411 of the Internal Revenue Code (26 U.S.C. §6411).[3] On its Form 1139 Application, the Debtors claimed a net operating loss for the 2006 tax year, that it carried back to the 2004 tax year, resulting in an anticipated tax refund for the 2004 tax year in the approximate amount of $66 million dollars (the "Tax Refund").[4] The Debtors claim that the IRS reflected the Tax Refund on the Debtors' transcript of account as being allowed and credited to their account. However, the IRS did not release the Tax Refund to the Debtors.

On November 15, 2007, the Debtors filed the Motion. The Debtors argued that the IRS should have completed its examination of the Form 1139 Application and issued the refund by October 15, 2007, i.e., ninety days after the Debtors filed the Application. On November 28, 2007, the IRS objected to the Motion, arguing that (1) the Motion was not ripe for consideration because the IRS's response to the Debtors' Form 1139 Application was not due until December 31, 2007, based on extensions given to the Debtors for filing their 2006 tax return, and (2) this Court is without jurisdiction to review the IRS's failure to act on the Form 1139 Application.

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[3]Form 1139 is also referred to as an application for a tentative carryback adjustment and may be referred to as the "Form 1139 Application" or the "Application" herein.

[4]The Debtors' net operating losses in 2006, underlying the claim for a substantial tax refund for tax year 2004, can be traced, in part, to the acknowledged "accounting errors" that resulted in a need to restate their reported financial results for the first three quarters of 2006 relating to treatment of loan repurchase losses. *(See* The Debtors' pre-petition News Release dated February 7, 2007, attached as Ex. A to the Motion of the United States Trustee for an Order Directing the Appointment of a Chapter 11 Trustee or, in the alternative, an Examiner, docket no. 278.)

(*See* docket no. 3955). The parties agreed that the IRS would file another response to the Motion on or after December 31, 2007.

On December 31, 2007, the IRS filed its second objection to the Motion, arguing that it had denied the Debtor's Form 1139 Application and that this Court lacks jurisdiction to review the denial (the "Second Objection"). (*See* docket no. 4267). In a declaration attached to the Second Objection, the revenue agent stated that he denied the Form 1139 Application because:

> [The Application] contains errors of computation and material omissions which could not be corrected within 90 days from the last day of the month in which fell the last date prescribed by law including extensions for filing a return for the taxable year ended December 31, 2006.
>
> The [A]pplication contained errors of computation and material omissions due to the following reasons:
>
> a. An improper valuation of the inventory of loans as of December 31, 2006.
> b. An improper change in the method of accounting for the mark to market adjustment for the year ended December 31, 2006.
> c. The failure to provide information in response to the limited examination of the application for a tentative carryback adjustment as requested by the Revenue Agent.

See IRS Second Objection, ¶¶ 4-5 (docket no. 4267). On January 4, 2008, the Debtors filed a response to the Second Objection, arguing that the IRS's denial of its Application was based upon an examination that went beyond the limited scope of review permitted by 26 U.S.C. §6411 and, further, that the IRS had waived its sovereign immunity by filing a proof of claim in this case, thereby giving the Court jurisdiction pursuant to 11 U.S.C. §106(b). (*See* docket no. 4319).

A hearing to consider the Motion and the IRS's Second Objection was held on January 9, 2008, and the matter was taken under advisement.

DISCUSSION

The Debtors are seeking a tax refund based upon 26 U.S.C. §6411, which allows

taxpayers to use an expedited procedure to request tentative tax refunds based on loss carrybacks, rather than by initiating their refund request under the standard procedure provided by 26 U.S.C. §6402. The advantages and disadvantages of the "tentative refund" procedure are described in *The Columbia Gas System, Inc. v. United States*, 32 Fed.Cl. 318 (1994):

> The presumption of § 6411 is in favor of prompt refunds for taxpayers pinched by [net operating losses]. Although § 6411 offers the taxpayer a potentially quicker refund, it has potential drawbacks as well. A disallowance decision under § 6411, unlike a similar decision under § 6402, is not reviewable. Refunds made under § 6411 are also more vulnerable to recapture because, unlike refunds made under § 6402, they may be taken back without notice or a right to contest.

Id. at 323. The IRS denied the Debtors' Form 1139 Application. The Debtors claim the denial violates that the automatic stay, and, through the Motion, ask this Court for an order directing the IRS to release the Tax Refund.[5] The IRS argues that this Court lacks jurisdiction to consider the Debtors' Motion. Jurisdiction is a threshhold issue that must be addressed first.

The Debtors argue that the IRS has waived its sovereign immunity by filing a proof of claim against the Debtors for 2004 and 2005 income taxes, "thereby vesting this Court with jurisdiction over all factual and legal issues relevant to the Debtors' 2004 and 2005 tax years." Debtors' Response, docket no. 4319, p. 3. Section 106(b) provides:

> A governmental unit that has filed a proof of claim in the case is deemed to have waived sovereign immunity with respect to a claim against such governmental unit that is property of the estate and that arose out of the same transaction or occurrence out of which the claim of such governmental unit arose.

11 U.S.C. §106(b). The IRS disputes the Debtors' contention that the issues regarding the

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[5]The Debtors have argued that their Motion is not a claim for a tax refund, but is a motion to enforce compliance with 26 U.S.C. §6411. While it is not a "formal" claim for a tax refund, the Motion seeks an order directing the IRS to release a tax refund under §6411. Clearly the Motion is a request for a tax refund.

calculation of a net operating loss for tax year 2006 arise out of the same transaction or occurrence as its claim for 2004 and 2005 taxes. However, even if I agreed with the Debtors, Section 106(b), without more, does not provide jurisdiction for determining whether the IRS should release the Tax Refund to the Debtors. "[B]ankruptcy Code §106 does not provide a substantive or independent basis for asserting a claim against the government. ... [A] plaintiff ... seeking to use the waiver in §106 must demonstrate that a source outside of §106 entitles it to the relief sought." *Franklin Savings Corp. v. United States (In re Franklin Savings Corp.)*, 385 F.3d 1279, 1286 (10th Cir. 2004). *See also Graham v. United States (In re Graham)*, 981 F.2d 1135, 1138 (10th Cir. 1992) ("While the [debtors] argue correctly that section 106 of the Bankruptcy Code provides a waiver of sovereign immunity for refund claims under some circumstances, any such general governmental waiver of the right not to be sued does not waive other jurisdictional requirements.").

I turn next to the statutory provisions cited by the parties that affect jurisdiction in this matter. First, the IRS argues that this Court lacks jurisdiction over the Debtors' Motion under §6411, which provides, in part, that "the Secretary may disallow, without further action, any application which he finds contains errors of computation which he deems cannot be corrected by him within such 90-day period or material omissions." 26 U.S.C. §6411(b)(2008). The applicable regulations regarding this section further provide:

> [A district director or director of a service center's] action in disallowing, in whole or in part, any application for a tentative carryback adjustment shall be final and may not be challenged in any proceeding. The taxpayer in such case, however, may file a claim for credit or refund under section 6402, and may maintain a suit based on such claim if it is disallowed or if such internal revenue officer does not act upon the claim within 6 months from the date it is filed.

26 C.F.R. §1.6411-3(c) (eff. to Aug. 26, 2007).[6]

In response, the Debtors contend that § 6411 does not grant unlimited discretion to the IRS but, instead, sets specific guidelines, permitting a review of Form 1139 applications, which is limited only to a determination of whether there are mathematical errors or omissions in the application. The Debtors argue that, in this case, the IRS exceeded its review authority when it incorrectly questioned the valuation and accounting methods used by the Debtors' in determining the net operating loss for tax year 2006. The Debtors claim that this Court has jurisdiction to decide whether the IRS abused its discretion and violated those guidelines.

Section 6411 provides, in pertinent part:

> (b) **Allowance of adjustments.** Within a period of 90 days from the date on which an application for tentative carryback adjustment is filed under subsection (a), or from the last day of the month in which falls the last date prescribed by law (including any extension of time granted the taxpayer) for filing the return for the taxable year of the net operating loss, net capital loss, or unused business credit from which such carryback results, whichever is later, the Secretary shall make, to the extent he deems practicable in such period, *a limited examination of the application, to discover omissions and errors of computation therein, and shall determine the amount of the decrease in the tax attributable to such carryback upon the basis of the application and the examination*, except that the Secretary may disallow, without further action, any application which he finds contains errors of computation which he deems cannot be corrected by him within such 90-day period or material omissions.

26 U.S.C. §6411(b)(2008) (emphasis added).

The Debtors focus on the high-lighted language of §6411, while ignoring the remaining language of the statute which permits the Secretary to deny an application - - without further action - - in the case of errors of computation or material omissions that cannot be corrected in 90

[6]Section 1.6411-3 of the Regulations was amended on August 27, 2007, but the amendment did not alter substantively the language quoted above. (*See* 72 F.R. 48933-01). The amendment applies to applications for tentative refunds filed on or after August 27, 2007. 26 C.F.R. §1.6411-3(e)(2008).

days. Here, the revenue agent has asserted that the Application has errors of computation and material omissions are present. Whether §6411 permits the IRS to look beyond the four corners of the Application in questioning the computations is less clear. However, the statute and applicable regulations are clear in stating that this Court may not review the IRS's denial of the Application.

Other courts have recognized that the denial of an application for a tentative carryback adjustment and refund is unreviewable. *See I.C.T.S. U.S.A., Inc. v. United States*, 2007 WL 512791 (S.D.N.Y. Feb. 15, 2007) (deciding that an application for tentative carryback adjustment is not a claim for credit or refund, and noting that, if such an application is denied, "no suit may be maintained in any court for recovery of any tax based upon such application."); *Schrader v. Internal Revenue Service*, 1975 WL 516 (W.D.Ky. Jan. 17, 1975) (dismissing a complaint alleging that the IRS had failed to pay her tax refunds upon filing of a tentative refund application); *Rock v. United States*, 279 F.Supp. 96, 99 (S.D.N.Y. 1968) (After discussing §6411's direction for limited examination of the application, the court also noted that "[d]isallowance of a tentative carryback adjustment is final and may not be challenged in any proceeding.").

While the IRS's denial of an application is not reviewable by a court, the taxpayer is not left without a remedy.

> Here, Congress has afforded the taxpayer an opportunity to seek speedy tax relief during the period immediately following a loss year, when such relief may be most sorely needed. If, however, a tentative application is disallowed, the taxpayer is still left with the option to pursue his claim for a refund in the normal manner. Reg. §1.6411-3(c).

Rock, 279 F.Supp. at 99. Accordingly, under §6411, this Court does not have jurisdiction to

review the IRS's denial of the Debtors' Form 1139 Application.

The foregoing analysis is consistent with other statutory provisions in both the Internal Revenue Code and the Bankruptcy Code that do not allow a court to consider a tax refund case until the taxpayer has complied with the taxing authority's procedures for a refund. Section 7422(a) of the Internal Revenue Code provides:

> **(a) No suit prior to filing claim for refund.** No suit or proceeding shall be maintained in any court for the recovery of any internal revenue tax alleged to have been erroneously or illegally assessed or collected, ... or of any sum alleged to have been excessive or in any manner wrongfully collected, until a claim for refund or credit has been duly filed with the Secretary, according to the provisions of law in that regard, and the regulations of the Secretary established in pursuance thereof.

26 U.S.C. §7422(a). An application for a tentative carry-back adjustment does not constitute a claim for a credit or refund. 26 C.F.R. 1.6411-1(b)(2). *See also I.C.T.S.*, 2007 WL 512791 at *1 *citing Rock*, 279 F.Supp. at 98-99 ("[t]he differences between an application for a tentative carryback adjustment and a claim for refund are not merely formal; they are substantive, and the statute and regulations...so state."). Section 7422 does not permit a court to consider a tax refund suit until the IRS's claim procedures are followed.

Moreover, Section 505 of the Bankruptcy Code provides that a bankruptcy court may not determine "any right of the estate to a tax refund, before the earlier of - - (i) 120 days after the trustee properly requests such refund from the governmental unit from which such refund is claimed; or (ii) a determination by such governmental unit of such request." 11 U.S.C. §505(a)(2)(B). In the decision *City of Perth Amboy v. Custom Distrib. Serv., Inc. (In re Custom Distrib. Serv., Inc.)*, 224 F.3d 235 (3d Cir. 2000), the Third Circuit Court of Appeals reviewed "the legislative history of §505(a), the overwhelming case authority interpreting it as precluding

the bankruptcy court from adjudicating claims for refund of taxes that were not seasonably contested in accordance with procedures set out by the taxing authority, and the policy considerations underpinning §505" and held that a bankruptcy court did not have jurisdiction to order a city to refund excess tax payments when the debtor did not contest those payments in accordance with the applicable state tax laws. *Custom Distrib.*, 224 F.3d at 243-44. *See also ANC Rental Corp v. County of Allegheny (In re ANC Rental Corp.)*, 316 B.R. 146 (Bankr.D.Del. 2004).

Analysis of each of these statutes and the judicial decisions interpreting them inform this Court that it does not have jurisdiction to consider the Debtors' request for a order directing the IRS to release a tax refund when only a Form 1139 Application has been filed. There is no dispute that the Debtors have not filed a claim for the Tax Refund with the IRS.[7] The Debtors' Motion will be dismissed for lack of jurisdiction.

An appropriate order will be entered.

BY THE COURT:

KEVIN J. CAREY
UNITED STATES BANKRUPTCY JUDGE

Dated: February 14, 2008

[7]The Debtors acknowledged that this was so at the time of the hearing on the Motion.

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

In re	:	**Chapter 11**
CAPMARK FINANCIAL GROUP INC., *et al.*,	:	**Case No. 09-13684 (CSS)**
Debtors.	:	**Jointly Administered**

PROPOSED SECOND AMENDED DISCLOSURE STATEMENT FOR JOINT PLAN OF CAPMARK FINANCIAL GROUP INC. AND CERTAIN AFFILIATED PROPONENT DEBTORS UNDER CHAPTER 11 OF THE BANKRUPTCY CODE

THIS IS NOT A SOLICITATION OF ACCEPTANCES OR REJECTIONS OF ANY CHAPTER 11 PLAN DESCRIBED HEREIN. ACCEPTANCES OR REJECTIONS OF A CHAPTER 11 PLAN MAY NOT BE SOLICITED UNTIL A DISCLOSURE STATEMENT HAS BEEN APPROVED BY THE BANKRUPTCY COURT. THIS DISCLOSURE STATEMENT HAS BEEN SUBMITTED FOR BANKRUPTCY COURT APPROVAL BUT HAS NOT BEEN APPROVED BY THE BANKRUPTCY COURT.

THE PROPONENT DEBTORS RESERVE THE RIGHT TO AMEND OR SUPPLEMENT THIS PROPOSED DISCLOSURE STATEMENT AT OR BEFORE THE HEARING TO CONSIDER APPROVAL OF THIS DISCLOSURE STATEMENT. [1]

DEWEY & LEBOEUF LLP
1301 Avenue of the Americas
New York, New York 10019
Tel: 212.259.8000

Co-Attorneys for the Debtors and
Debtors in Possession

RICHARDS, LAYTON & FINGER, P.A.
One Rodney Square
920 North King Street
Wilmington, Delaware 19801
Tel: 302.651.7700

Co-Attorneys for the Debtors and
Debtors in Possession

Dated: July 8, 2011

[1] This text box will be removed upon issuance of the Disclosure Statement Order by the Bankruptcy Court. All references to the "proposed" Disclosure Statement will also be removed upon the Bankruptcy Court's issuance of the Disclosure Statement Order.

In deciding whether to vote to accept or reject the Plan, holders of Claims must make their own determination as to the reasonableness of such assumptions and the reliability of the projected recoveries and should consult with their own advisors.

The Recovery Analysis should be read in conjunction with the assumptions, qualifications, and explanations set forth in this Disclosure Statement, including in the Sections titled "Description and History of Capmark's Businesses", "The Chapter 11 Plan", "Risk Factors and Other Factors to be Considered," and "Certain United States Federal Income Tax Consequences of the Plan." *See* Sections III, VI, VII, and XI. The Recovery Analysis should also be read in conjunction with the assumptions, qualifications, and explanations set forth in Exhibit D.

XI. CERTAIN UNITED STATES FEDERAL INCOME TAX CONSEQUENCES OF THE PLAN

A. Scope and Limitation

The following discussion summarizes certain U.S. federal income tax consequences of the implementation of the Plan to certain Proponent Debtors and holders of Claims. The discussion also summarizes certain U.S. federal income tax consequences of the ownership and disposition of the A Notes and B Notes by certain holders of Claims. It does not, however, summarize the U.S. federal income tax consequences to such holders of the ownership and disposition of the Reorganized CFGI Common Stock. Holders of Claims should consult their own tax advisors regarding the consequences of the ownership and disposition of Reorganized CFGI Common Stock.

This discussion is based on the Tax Code, Treasury Regulations promulgated thereunder, judicial decisions, and published administrative rules and pronouncements of the IRS, each as in effect on the date hereof. Legislative, judicial, or administrative changes or interpretations enacted or promulgated after the date hereof could alter or modify the discussion set forth below with respect to the U.S. federal income tax consequences of the Plan. Any such changes or interpretations may be retroactive and could significantly affect the U.S. federal income tax consequences described herein.

This discussion does not address the U.S. federal income tax consequences to holders of Claims who (a) are unimpaired or otherwise entitled to payment in full in Cash on the Effective Date under the Plan or (b) are otherwise not entitled to vote under the Plan. The discussion also does not address the U.S. federal income tax consequences related to the Claim of a holder that is itself a Proponent Debtor, Non-Proponent Debtor, or non-debtor Affiliate. Moreover, the discussion assumes that Claims are against only CFGI, each holder of a Claim holds only Claims in a single class, each holder of a Claim holds such Claims only as "capital assets" within the meaning of the Tax Code, none of the Claims has "original issue discount" ("OID") within the meaning of the Tax Code, and the various debt and other arrangements to which the Proponent Debtors and Reorganized Debtors are or will be parties will be respected for U.S. federal income tax purposes in accordance with their form.

The U.S. federal income tax consequences of the Plan are complex and are subject to substantial uncertainties. The Proponent Debtors have not requested, and do not expect to request, a ruling from the IRS with respect to any of the tax aspects of the Plan, and the discussion set forth below of certain U.S. federal income tax consequences of the Plan is not binding upon the IRS. Thus, no assurance can be given that the IRS would not assert, or that a court would not sustain, a position different from any discussed herein, resulting in U.S. federal income tax consequences to the Proponent Debtors, holders of Claims, or both that are substantially different from those discussed herein. The Proponent

Debtors have not requested, and do not expect to request, an opinion of counsel with respect to any of the tax aspects of the Plan, and no opinion is given by this Disclosure Statement.

This discussion does not apply to a holder of a Claim that is not a "United States person," as such term is defined in the Tax Code. Moreover, this discussion does not address U.S. federal taxes other than income taxes or any state, local, or non-U.S. tax consequences of the Plan, nor does it purport to address all aspects of U.S. federal income taxation that may be relevant to United States persons in light of their individual circumstances or to United States persons that may be subject to special tax rules, such as persons who are related to the Proponent Debtors within the meaning of the Tax Code, broker-dealers, banks, mutual funds, insurance companies, financial institutions, small business investment companies, regulated investment companies, tax-exempt organizations, pass-through entities, beneficial owners of pass-through entities, subchapter S corporations, employees, persons who received their Claims as compensation, persons who hold Claims or who will hold Reorganized CFGI Common Stock or Reorganized CFGI Debt Securities as part of a straddle, hedge, conversion transaction, or other integrated investment, persons using a mark to market method of accounting, and holders of Claims who are themselves in bankruptcy. If a partnership or entity treated as a partnership for U.S. federal income tax purposes holds Claims, the tax treatment of a partner generally will depend on the status of the partner and the activities of the partnership.

THE FOLLOWING SUMMARY OF CERTAIN U.S. FEDERAL INCOME TAX CONSEQUENCES IS FOR INFORMATIONAL PURPOSES ONLY AND IS NOT A SUBSTITUTE FOR CAREFUL TAX PLANNING AND ADVICE BASED UPON THE INDIVIDUAL CIRCUMSTANCES PERTAINING TO A HOLDER OF A CLAIM. ALL HOLDERS OF CLAIMS ARE URGED TO CONSULT THEIR OWN TAX ADVISORS AS TO THE FEDERAL, STATE, LOCAL, NON-U.S. INCOME, ESTATE, GIFT, AND OTHER TAX CONSEQUENCES OF THE PLAN AND OF THE OWNERSHIP AND DISPOSITION OF THE A NOTES AND B NOTES.

IRS CIRCULAR 230 DISCLOSURE: ANY TAX ADVICE CONTAINED IN THIS DISCLOSURE STATEMENT (INCLUDING ANY ATTACHMENTS) IS NOT INTENDED OR WRITTEN TO BE USED, AND CANNOT BE USED, BY ANY TAXPAYER FOR THE PURPOSE OF AVOIDING TAX-RELATED PENALTIES UNDER THE TAX CODE. TAX ADVICE CONTAINED IN THIS DISCLOSURE STATEMENT (INCLUDING ANY ATTACHMENTS) IS WRITTEN IN CONNECTION WITH THE PROMOTION OR MARKETING OF THE TRANSACTIONS OR MATTERS ADDRESSED BY THE DISCLOSURE STATEMENT. EACH TAXPAYER SHOULD SEEK ADVICE BASED ON THE TAXPAYER'S PARTICULAR CIRCUMSTANCES FROM AN INDEPENDENT TAX ADVISOR.

B. Certain U.S. Federal Income Tax Consequences to the Proponent Debtors

For U.S. federal income tax purposes, CFGI is the common parent of an affiliated group of corporations that files a single consolidated U.S. federal income tax return (the "Capmark Consolidated Group"). The Proponent Debtors are members of the Capmark Consolidated Group or are disregarded or pass-through entities for U.S. federal income tax purposes wholly or substantially owned by members of the Capmark Consolidated Group. For U.S. federal income tax purposes, the Capmark Consolidated Group's estimated NOL carryforwards as of December 31, 2010, were approximately $2.7 billion. The amount of these NOLs and other losses remains subject to audit and adjustment by the IRS.

As discussed below, it is anticipated that a substantial portion of the losses and other tax attributes of the Capmark Consolidated Group will be utilized or eliminated in connection with the implementation of the Plan. It is further anticipated that the use of remaining losses by the Capmark Consolidated Group to offset future taxable income will be subject to significant limitation. In addition,

the tax basis of the assets held by certain members of the Capmark Consolidated Group may be reduced in connection with implementation of the Plan.

There also may be other U.S. federal income tax consequences to the Proponent Debtors as a result of certain restructuring transactions.

1. Cancellation of Indebtedness Income

As a result of the Plan, CFGI's existing indebtedness will be eliminated.

Generally, a corporation will recognize cancellation of indebtedness income ("COD Income") upon satisfaction of its outstanding indebtedness for total consideration less than the amount of such indebtedness. A corporation will not, however, be required to include any amount of COD Income in gross income if the corporation is a debtor under the jurisdiction of a court in a case under chapter 11 of the Bankruptcy Code and the discharge of debt occurs pursuant to that proceeding (the "108(a) Bankruptcy Exception"). Instead, as a consequence of such exclusion, the debtor must reduce its tax attributes by the amount of COD Income excluded from gross income. In general, tax attributes are reduced in the following order: (a) NOLs, (b) general business and minimum tax credit carryforwards, (c) capital loss carryforwards, (d) the basis of the debtor's assets, and (e) foreign tax credit carryforwards.

If a debtor with excluded COD Income is a member of a consolidated group, Treasury Regulations address the application of the rules for the reduction of tax attributes (the "Consolidated Attribute Reduction Rules"). The Consolidated Attribute Reduction Rules generally provide that the tax attributes attributable to the member with excluded COD Income are reduced first, including the member's tax basis in its assets (which include the stock of subsidiaries). If the member reduces its basis in the stock of a subsidiary that is a member of the consolidated group, corresponding reductions must be made to the subsidiary's tax attributes, including the subsidiary's basis in its assets. Generally, any required attribute reduction takes place after the consolidated group has determined its taxable income (or loss) for the taxable year in which the COD Income is incurred.

CFGI expects to incur COD Income as a result of the Plan. The amount of COD Income will depend on, among other things, the fair market value of the Reorganized CFGI Common Stock and the "issue price" of the Reorganized CFGI Debt Securities (*see* Section XI.C.3.a.(ii) below), and these amounts may not be determined until after the Effective Date of the Plan. In addition, the treatment of the Crystal Ball Payment (as defined in Section XI.C.1 below) and Disputed Claims Reserve may affect the amount of CFGI's COD Income. Pursuant to the 108(a) Bankruptcy Exception, CFGI will not include its COD Income in gross income. Instead, CFGI will be required to reduce its tax attributes in accordance with the Consolidated Attribute Reduction Rules after determining the taxable income (or loss) of the Capmark Consolidated Group for the taxable year of discharge.

Under the Consolidated Attribute Reduction Rules, CFGI's excluded COD Income will be applied to reduce CFGI's NOLs and, if necessary, other tax attributes, including CFGI's tax basis in its assets. To the extent that the amount of excluded COD Income results in a reduction in the basis of the stock of members of the Capmark Consolidated Group, the Consolidated Attribute Reduction Rules require these members to reduce their tax attributes accordingly, including, among other things, the tax basis in their assets.

The extent, if any, to which NOLs and other tax attributes remain following the application of the Consolidated Attribute Reduction Rules will depend on a number of factors, including (a) the amount of COD Income and (b) certain tax consequences of the Subsidiary Conversions (as defined in Section XI.B.3 below).

2. Annual Section 382 Limitation on Use of NOLs and "Built-In" Losses and Deductions

a. *Limitation on NOLs and Other Tax Attributes*

Under section 382 of the Tax Code, if a "loss corporation" (generally, a corporation with NOLs and/or built-in losses) undergoes an "ownership change," the amount of its pre-ownership change NOLs (the "Pre-Change Losses") that may be utilized to offset future taxable income generally is subject to an annual limitation (the "Annual Section 382 Limitation"). Similar rules apply to the corporation's capital loss carryforwards and tax credits.

CFGI's issuance of Reorganized CFGI Common Stock pursuant to the Plan is expected to result in an ownership change for purposes of section 382 of the Tax Code. Accordingly, the Capmark Consolidated Group's Pre-Change Losses should be subject to the Annual Section 382 Limitation. This limitation applies in addition to, and not in lieu of, any other limitation that may already or in the future be in effect and the attribute reduction that may result from COD Income and the Subsidiary Conversions.

b. *General Section 382 Limitation*

In general, the amount of the Annual Section 382 Limitation is equal to the product of (1) the fair market value of the stock of the loss corporation (or, in the case of a consolidated group, generally the stock of the common parent) immediately before the ownership change (with certain adjustments) and (2) the "long-term tax-exempt rate" in effect for the month in which the ownership change occurs (for example, 4.30% for an ownership change that occurs during April 2011). For a corporation (or consolidated group) in bankruptcy that undergoes an ownership change pursuant to a confirmed bankruptcy plan of reorganization, the stock value generally is determined immediately after (rather than before) the ownership change.

Any unused portion of the Annual Section 382 Limitation generally may be carried forward, thereby increasing the Annual Section 382 Limitation in the subsequent taxable year. However, if the corporation (or consolidated group) does not continue its historic business or use a significant portion of its assets in a business for two years after the ownership change, the Annual Section 382 Limitation is reduced to zero. In addition, if a redemption or other corporate contraction occurs in connection with the ownership change of the loss corporation (or consolidated group), or if the loss corporation (or consolidated group) has substantial nonbusiness assets, the Annual Section 382 Limitation is reduced to take the redemption, other corporate contraction, or nonbusiness assets into account. Furthermore, if the corporation (or consolidated group) undergoes a second ownership change, the second ownership change may result in a lesser (but never a greater) Annual Section 382 Limitation with respect to any losses that existed at the time of the first ownership change.

c. *Built-in Gains and Losses*

If a loss corporation (or consolidated group) has a "net unrealized built-in loss" at the time of the ownership change, then any built-in losses or deductions recognized during the following five years (up to the amount of the original net unrealized built-in loss) generally will be treated as a Pre-Change Loss subject to the Annual Section 382 Limitation. Conversely, if the loss corporation (or consolidated group) has a "net unrealized built-in gain" at the time of the ownership change, then any built-in gains recognized during the following five years (up to the amount of the original net unrealized built-in gain) will increase the Annual Section 382 Limitation in the year recognized.

d. *Special Bankruptcy Exceptions*

Section 382(*l*)(5) of the Tax Code provides an exception to the application of the Annual Section 382 Limitation when a corporation is under the jurisdiction of a bankruptcy court in a title 11 case (the "382(*l*)(5) Bankruptcy Exception"). This exception generally applies where (1) shareholders of a debtor immediately before an ownership change and (2) qualified creditors (generally, historic creditors) of the debtor, in respect of their interests and claims, receive stock with at least 50 percent of the voting power and value of all the stock of the reorganized debtor. Under the 382(*l*)(5) Bankruptcy Exception, a debtor's Pre-Change Losses are not limited on an annual basis but, instead, are required to be reduced by the amount of any interest deductions claimed during the three taxable years preceding the effective date of the reorganization, and during the part of the taxable year before and including the reorganization, in respect of all debt converted into stock in the reorganization. Moreover, if the 382(*l*)(5) Bankruptcy Exception applies, a second ownership change of the debtor within a two-year period after the bankruptcy plan of reorganization generally will cause the debtor to forfeit all its unused NOLs that were incurred before the second ownership change. If a debtor qualifies for the 382(*l*)(5) Bankruptcy Exception, the exception applies unless the debtor affirmatively elects for it not to apply.

If a debtor in bankruptcy is not eligible for the 382(*l*)(5) Bankruptcy Exception or elects out of the exception, a special rule under section 382(*l*)(6) of the Tax Code will apply for purposes of determining the Annual Section 382 Limitation. Under this special rule, the Annual Section 382 Limitation will be calculated by reference to the lesser of (1) the value of the debtor's stock (with certain adjustments) immediately after the ownership change (as opposed to immediately before the ownership change, as described above) or (2) the value of the debtor's assets (determined without regard to liabilities) immediately before the ownership change.

e. *Application of Section 382 to Capmark*

As discussed above, it is expected that the Capmark Consolidated Group will undergo an ownership change as a result of the implementation of the Plan. To the extent that the 382(*l*)(5) Bankruptcy Exception is available, the Capmark Consolidated Group intends to elect out of the exception. Accordingly, the Capmark Consolidated Group expects that the use of NOLs after the Effective Date of the Plan will be subject to limitation based on the rules discussed above (other than the 382(*l*)(5) Bankruptcy Exception), but taking into account the special rule under section 382(*l*)(6) of the Tax Code. Certain aspects of the law pertaining to the Annual Section 382 Limitation rules discussed above are unclear and depend on, among other things, factual determinations that may not be able to be made as of the Effective Date. As a result, there is substantial uncertainty with respect to the Annual Section 382 Limitation of the Capmark Consolidated Group, and there can be no assurance that the limitation will not be significantly lower than anticipated.

In addition, if there were an ownership change prior to the Effective Date, the Annual Section 382 Limitation resulting from the implementation of the Plan might result in a lesser (but not a greater) limitation with respect to losses that existed at the time of the first ownership change.

3. Conversions of Certain Proponent Debtors into Limited Liability Companies and Election to Classify Crystal Ball as a Disregarded Entity

After the Confirmation Date and on or before the Effective Date, certain of the Proponent Debtors not currently organized as limited liability companies under applicable law, including CFI, CCI, and CEI, may convert into limited liability companies (such conversions, the "Subsidiary Conversions"). In general, it is expected that the Subsidiary Conversions should be treated, for U.S. federal income tax purposes, as taxable liquidations of the converting Proponent Debtors. As a result, as regards the

conversions of CFI, CCI, CEI, and any other converting Proponent Debtors, CFGI expects to recognize a loss with respect to its stock of each subsidiary in an amount equal to its basis in such stock as of the subsidiary's conversion. In addition, CFGI expects to recognize losses with respect to certain intercompany receivables. As a result of the Subsidiary Conversions, under certain Treasury Regulations, the NOLs (as well as other tax attributes) of CFI, CCI, CEI, and the other converting Proponent Debtors should be eliminated.

In addition, Crystal Ball may elect to be classified as a Disregarded Entity, with the election effective on or before the Effective Date.

4. Alternative Minimum Tax

In general, a federal alternative minimum tax ("AMT") is imposed on a corporation's alternative minimum taxable income ("AMTI") each year at a 20% rate to the extent that such tax exceeds the corporation's regular federal income tax for such year. AMTI is generally equal to regular taxable income with certain adjustments. For purposes of computing AMTI, certain tax deductions and other beneficial allowances are modified or eliminated. In particular, even though a corporation may otherwise be able to offset all of its taxable income for regular tax purposes by available NOLs, only 90% of a corporation's AMTI generally may be offset by available alternative tax NOLs.

In addition, if a corporation or consolidated group undergoes an ownership change within the meaning of section 382 of the Tax Code and has a net unrealized built-in loss at the time of such change, the corporation's or consolidated group's aggregate basis in its assets would be reduced for certain AMT purposes to reflect the fair market value of such assets as of the date of the ownership change.

Any AMT that a corporation pays generally will be allowed as a nonrefundable credit against its regular federal income tax liability in future years when the corporation is not subject to the AMT. Any unused credit is carried forward indefinitely.

5. Applicable High-Yield Discount Obligations

It is possible that certain of the Reorganized CFGI Debt Securities could be treated as "applicable high-yield discount obligations" (such obligation, an "AHYDO"). In general, an AHYDO is any debt instrument with "significant original issue discount," a maturity date that is more than five years from the issue date, and a yield to maturity that is at least five percentage points higher than the applicable federal rate on the issue date. If a debt instrument is treated as an AHYDO, the issuer may be permanently denied a deduction for a portion of the OID on such instrument and may claim an interest deduction as to the remainder of the OID only when such portion is paid in cash. In general, the AHYDO provisions may be avoided if there is no significant OID at the end of each accrual period after the fifth anniversary of the original issuance of the debt instrument.

The terms of the Reorganized CFGI Debt Securities potentially susceptible to AHYDO treatment include a provision that will require Reorganized CFGI to pay at the end of each accrual period ending after the fifth anniversary of the issuance date (if applicable) the minimum amount of principal plus accrued interest necessary to prevent the application of the AHYDO rules. Accordingly, it is not currently anticipated that the Reorganized CFGI Debt Securities will be subject to the AHYDO rules, but no assurance can be given that the IRS might not assert otherwise.

C. Certain U.S. Federal Income Tax Consequences to Holders of Claims Against CFGI

1. Certain Consequences to Holders of Allowed General Unsecured Claims Against CFGI

Pursuant to the Plan, each holder of an Allowed General Unsecured Claim against CFGI (a "CFGI Holder") will receive a Proportionate Enterprise Share of the Cash Distribution, Reorganized CFGI Common Stock, and Reorganized CFGI Debt Securities in exchange for such Allowed General Unsecured Claim. For U.S. federal income tax purposes, a CFGI Holder should realize gain or loss (if any) equal to the difference between the holder's amount realized with respect to the exchange of its claim and the holder's adjusted tax basis in its claim. Subject to the discussion of accrued interest in Section XI.C.2.b below, a CFGI Holder's amount realized should include (a) the fair market value of the Reorganized CFGI Common Stock, (b) the issue price of the Reorganized CFGI Debt Securities, and (c) the Cash Distribution received by the holder.

On the Effective Date, certain CFGI Holders will receive Cash, and the right to receive additional Cash after the Effective Date, in connection with the Crystal Ball Settlement Agreement (such receipt of Cash and the right to receive additional Cash, a "Crystal Ball Payment"). In addition, CFGI Holders, after the Effective Date, may receive Cash, Reorganized CFGI Common Stock, and Reorganized CFGI Debt Securities from the Disputed Claims Reserve as a result of determinations with respect to Disputed Claims (a "Disputed Claims Payment"). This discussion generally does not address the U.S. federal income tax consequences of a Crystal Ball Payment or Disputed Claims Payment (although certain consequences relating to the Disputed Claims Reserve are addressed in Section XI.D below). A CFGI Holder should consult its tax advisor regarding the tax consequences of such a payment. These tax consequences include the treatment of a Crystal Ball Payment or Disputed Claims Payment in determining the amount realized by the holder with respect to its Allowed General Unsecured Claim, as well as the tax consequences related to the right to receive consideration prospectively, including the amount required to be taken into account with respect to the receipt of the right, the consequences of holding the right, the treatment and characterization of payments received after the Effective Date with respect to the right, and the potential deferral of the recognition of any loss realized with respect to an Allowed General Unsecured Claim until all consideration related to the claim is determined and received.

The recognition of gain realized by a CFGI Holder may be affected by the installment method of reporting gain. This discussion assumes that such method either is not available with respect to the holder's exchange of its Allowed General Unsecured Claim or, if available, the holder elects out of such method. CFGI Holders should consult their tax advisors regarding the availability and application of (and, if available, the election out of) the installment method of reporting gain that may be recognized with respect to their claims.

The recognition of gain or loss realized by a CFGI Holder also may be affected by whether the holder's Allowed General Unsecured Claim and the A Notes or B Notes constitute "securities" for U.S. federal income tax purposes.

a. *Securities for Tax Purposes*

Whether a debt instrument constitutes a "security" for U.S. federal income tax purposes is determined based on all of the facts and circumstances. Certain authorities have held that one factor to be considered is the length of the initial term of the debt instrument. These authorities have held that an initial term of less than five years is evidence that the instrument is not a security; whereas, an initial term of ten years or more is evidence that it is a security. Numerous factors other than the term of an instrument could be taken into account in determining whether a debt instrument is a security, including

whether repayment is secured, the degree of subordination of the instrument, the creditworthiness of the obligor, whether the holders have the right to vote or otherwise participate in the management of the obligor, whether the instrument is convertible into an equity interest of the obligor, whether payments of interest are fixed, variable, or contingent, and whether such payments are made on a current basis or are accrued.

Each CFGI Holder should consult its tax advisor to determine whether the debt underlying its Allowed General Unsecured Claim, the A Notes, or the B Notes constitute securities for U.S. federal income tax purposes.

b. *Allowed General Unsecured Claims Constituting Securities*

If the debt underlying a holder's Allowed General Unsecured Claim constitutes a security in CFGI, the exchange of the Allowed General Unsecured Claim may qualify as a recapitalization or other nonrecognition transaction for U.S. federal income tax purposes. In such case, a CFGI Holder that realizes a loss on the exchange would not be permitted to recognize the loss.

If the exchange of an Allowed General Unsecured Claim is a recapitalization, and if either the A Notes or B Notes (or both) constitute securities for U.S. federal income tax purposes, a CFGI Holder that realizes gain on the exchange generally should recognize gain, for U.S. federal income tax purposes, equal to the lesser of (1) the amount of gain realized and (2) the amount of consideration received other than Reorganized CFGI Common Stock or Reorganized CFGI Debt Securities that constitute securities for U.S. federal income tax purposes (collectively, "Boot"). The character of such recognized gain as capital gain or as ordinary income should depend on, among other things, the application of the "market discount" rules (*see* Section XI.C.2.a below). In addition, as discussed in Section XI.C.2.b below, a holder may recognize ordinary income to the extent that a portion of the consideration received in exchange for an Allowed General Unsecured Claim is treated as received in satisfaction of accrued but untaxed interest on the Allowed General Unsecured Claim. If recognized gain is capital gain, it generally would be long-term capital gain if the holder held its Allowed General Unsecured Claim for more than one year at the time of the exchange. The CFGI Holder's tax basis in the Reorganized CFGI Common Stock and securities it receives in exchange for its Allowed General Unsecured Claim generally should equal the sum of (1) the holder's tax basis in the Allowed General Unsecured Claim and (2) the amount of gain recognized on the exchange, reduced by the Boot received. This basis is allocable between the Reorganized CFGI Common Stock and securities received based on their relative fair market values. The CFGI Holder generally should have a holding period for the Reorganized CFGI Common Stock and securities that includes the holding period of the Allowed General Unsecured Claim. These basis and holding period results may vary if the Reorganized CFGI stock or securities are treated as received in satisfaction of accrued but untaxed interest. A holder's basis in any A Notes or B Notes that do not constitute securities should be equal to the fair market value of the Notes, and the holding period for such notes generally should begin on the day following the Effective Date.

If the exchange of an Allowed General Unsecured Claim is a recapitalization, and if neither the A Notes nor B Notes constitute securities for U.S. federal income tax purposes, a CFGI Holder that realizes gain on the exchange generally should recognize gain, for U.S. federal income tax purposes, equal to the lesser of (1) the amount of gain realized and (2) the amount of any Boot received, which would include the issue price of the A Notes and B Notes. Similar to the immediately preceding paragraph, the character of such recognized gain as capital gain or as ordinary income should depend, among other things, on the application of the market discount rules, and a holder may recognize ordinary income to the extent that a portion of the consideration received in exchange for an Allowed General Unsecured Claim is treated as received in satisfaction of accrued but untaxed interest on the Allowed General Unsecured Claim. If recognized gain is capital gain, it generally would be long-term capital gain

if the holder held its Allowed General Unsecured Claim for more than one year at the time of the exchange. The holder's tax basis in the Reorganized CFGI Common Stock it receives in exchange for its Allowed General Unsecured Claim generally should equal the sum of (1) the holder's tax basis in the Allowed General Unsecured Claim and (2) the amount of gain recognized on the exchange, reduced by the amount of any Boot received, which includes the issue price of the A Notes and B Notes. The CFGI Holder generally should have a holding period for the Reorganized CFGI Common Stock that includes the holding period of the Allowed General Unsecured Claim. These basis and holding period results may vary if Reorganized CFGI Common Stock is treated as received in satisfaction of accrued but untaxed interest. A holder's basis in A Notes or B Notes received should be equal to the fair market value of the Notes, and the holding period for such Notes generally should begin on the day following the Effective Date.

c. *Allowed General Unsecured Claims Not Constituting Securities*

If the debt underlying a holder's Allowed General Unsecured Claim does not constitute a security, the exchange of the Allowed General Unsecured Claim for the consideration received should be treated as a taxable exchange for U.S. federal income tax purposes. The CFGI Holder generally should recognize the gain or loss realized on the exchange. The character of such recognized gain or loss as capital gain or loss or as ordinary income or loss should depend, among other things, on the application of the market discount rules, and a holder may recognize ordinary income to the extent that a portion of the consideration received in exchange for an Allowed General Unsecured Claim is treated as received in satisfaction of accrued but untaxed interest on the Allowed General Unsecured Claim. If recognized gain is capital gain, it generally would be long-term capital gain if the holder held its Allowed General Unsecured Claim for more than one year at the time of the exchange. In general, a CFGI Holder's basis in the property received should equal the fair market value of the property as of the Effective Date, and a holder's holding period for the property received should begin on the day following the Effective Date.

Each CFGI Holder should consult its tax advisor regarding whether (and the extent to which) the exchange of an Allowed General Unsecured Claim qualifies as a recapitalization or other nonrecognition transaction and, whether or not it so qualifies, the tax consequences to such holder of the exchange of an Allowed General Unsecured Claim for the consideration received by the CFGI Holder under the Plan.

2. Market Discount and Accrued Interest

a. *Market Discount*

The market discount provisions of the Tax Code may apply to certain CFGI Holders. In general, a debt obligation acquired by a holder in the secondary market is considered to be acquired with market discount as to that holder if its stated redemption price at maturity (or, in the case of a debt obligation having OID, its adjusted issue price) exceeds, by more than a statutory *de minimis* amount, the tax basis of the debt obligation in the holder's hands immediately after its acquisition.

Any gain recognized by a CFGI Holder on the exchange of an Allowed General Unsecured Claim that was acquired with market discount should be treated as ordinary income to the extent of the market discount that accrued thereon (unless the holder elected to include market discount in income as it accrued). In the case of an exchange of an Allowed General Unsecured Claim that qualifies as a recapitalization, any accrued market discount remaining on the claim, which has not been recognized as ordinary income as described in the previous sentence, likely should be carried over to the property received therefor and treated as accrued market discount on such property. Holders with accrued market

discount with respect to their Allowed General Unsecured Claims should consult their tax advisors as to the application of the market discount rules in view of their particular circumstances.

b. *Accrued Interest*

A portion of any Reorganized CFGI Common Stock, Reorganized CFGI Debt Securities, Cash, or other property received in exchange for an Allowed General Unsecured Claim may be treated as received in exchange for interest accrued but untaxed on the claim. To the extent that any portion of the consideration received by a holder is attributable to accrued but untaxed interest, the holder will recognize ordinary income if the holder has not previously included the accrued interest in income. Conversely, a CFGI Holder generally should recognize a loss to the extent any accrued interest was previously included in income and is not paid in full.

A holder's tax basis in any Reorganized CFGI Debt Securities or Reorganized CFGI Common Stock treated as received in exchange for accrued but untaxed interest (if any) generally will be equal to the fair market value of such Reorganized CFGI Debt Securities or Reorganized CFGI Common Stock as of the Effective Date. The holding period of such Reorganized CFGI Debt Securities or Reorganized CFGI Common Stock generally will begin on the day following the Effective Date.

The Plan provides that all amounts paid on a Claim that includes both principal and accrued but unpaid interest will be allocated first to the principal amount owing and only to interest to the extent the recovery exceeds the principal. There can be no assurance that the IRS will agree with such treatment. Each CFGI Holder should consult its tax advisor regarding the proper allocation of the consideration received under the Plan.

3. Certain U.S. Federal Income Tax Consequences of Ownership and Disposition of A Notes and B Notes

a. *Treatment of A Notes and B Notes*

(i) Trading on an Established Market

The U.S. federal income tax treatment of the A Notes and B Notes is subject to significant uncertainty and will depend, in part, upon whether, for purposes of the provisions of the Tax Code relating to OID and the Treasury Regulations promulgated thereunder (the "OID Regulations"), the Notes are traded on an established market or a substantial amount of the Notes is issued for Claims that are traded on an established market. Pursuant to the applicable Treasury Regulations, a debt instrument is traded on an "established market" if, among other things, (1) it appears on a system of general circulation (including a computer listing disseminated to subscribing brokers, dealers, or traders) that provides a reasonable basis to determine fair market value by disseminating either recent price quotations or actual prices of recent sales transactions or (2) in certain circumstances, price quotations for such debt instrument are readily available from dealers, brokers, or traders. Proposed regulations were recently published that would modify the determination of when property is treated as traded on an established market. The regulations, as proposed, apply to debt instruments issued after the regulations are adopted as final regulations.

Reorganized CFGI expects, and the following discussion assumes, that, under the above rules for determining whether property is traded on an established market, the A Notes and B Notes will be treated as so traded or a substantial amount of the A Notes and B Notes will be issued for Claims that are treated as so traded. If this is not the case, then rules that are substantially different from those

discussed below would apply to the A Notes and B Notes and the tax consequences to holders of the A Notes and B Notes would differ significantly from the consequences discussed below.

The rules discussed below can result in potentially significant adverse tax consequences. These tax consequences include, but are not limited to, the inclusion of amounts in gross income, regardless of whether a holder is a cash or accrual basis taxpayer, in advance of receipt of corresponding cash payments on the Notes, the potential treatment of amounts that might otherwise be viewed for non-tax purposes as returns of principal as payments of interest, and the treatment of any gain from the disposition of the Notes as ordinary income. CFGI Holders are strongly urged to consult their own tax advisors regarding the tax consequences of owning and disposing of the A Notes and B Notes, including the application of the rules discussed below in their particular circumstances and the consequences if (1) the A Notes or B Notes are not treated as traded on an established market and (2) a substantial amount of the A Notes or B Notes, as applicable, is not issued for Claims that are so treated.

(ii) Issue Price

If either the A Notes or B Notes are traded on an established market or a substantial amount of the A Notes or B Notes is issued for Claims that are traded on an established market, then all payments on the A Notes or B Notes, as applicable, likely will be governed by the provisions of the OID Regulations discussed below. In general, if the A Notes or B Notes are traded on an established market, the issue price of an A Note or B Note, as applicable, will be its fair market value as of the Effective Date. If the A Notes or B Notes are not traded on an established market, but a substantial amount of the A Notes or B Notes, as applicable, is issued for Claims that are traded on an established market, then the issue price of the A Notes or B Notes should be determined by allocating the fair market value of such Claims as of the Effective Date among the A Notes or B Notes, as applicable, the Reorganized CFGI Common Stock, and any other property issued in exchange for such Claims, based on the relative fair market values of such Notes, stock, and other property. In such case, Reorganized CFGI's determination as to the foregoing allocation will be binding on holders of the A Notes or B Notes, as applicable, unless a holder explicitly discloses in a timely filed U.S. federal income tax return for a taxable year that includes the Effective Date that its allocation is different than Reorganized CFGI's allocation.

(iii) Accrual of OID

It appears that the accrual of any amount payable with respect to the Notes generally will be governed by the OID Regulations applicable to "contingent payment debt instruments" ("CPDIs"). This is due to the fact that the A Notes and B Notes contemplate certain contingent payments, including payments of increased amounts in certain circumstances and certain mandatory prepayments. The rest of this discussion assumes that the OID Regulations applicable to CPDIs that are traded on an established market or that are exchanged for property that is so traded ("Publicly Traded CPDIs"), discussed below, are applicable to the Notes.

Under the OID Regulations applicable to Publicly Traded CPDIs, a holder will be required to include in gross income as OID that portion of the OID attributable to each day during a taxable year that the holder held the Notes. The daily portion of OID is determined by allocating to each day of any accrual period within a taxable year a pro rata portion of an amount equal to the product of such Note's "adjusted issue price" at the beginning of the accrual period and its "comparable yield."

In general, the comparable yield of the A Notes or B Notes will be equal to the yield, as reasonably determined by Reorganized CFGI, at which Reorganized CFGI would issue a fixed rate debt instrument with terms and conditions similar to those of the A Notes or B Notes (as applicable), including the level of subordination, term, timing of payments, and general market conditions. The adjusted issue

price of the A Notes or B Notes at the beginning of an accrual period will equal their issue price plus the amount of OID previously includible in the gross income of the holder (determined without regard to any adjustments to OID accruals discussed below) and decreased by the amount of any noncontingent payment and the amount shown on the projected payment schedule (described below) of any contingent payment previously made on the Notes. Special rules apply where a holder's tax basis in the A Notes and/or B Notes differs from their adjusted issue price, such as where the exchange of an Allowed General Unsecured Claim is a recapitalization and the A Notes and/or B Notes, as applicable, constitute securities for tax purposes (*see* Section XI.C.1.b above).

Reorganized CFGI generally will be required to construct a schedule of projected payments for the A Notes or B Notes reflecting all expected contingent payments and adjusted to reflect the comparable yield. Depending on the facts and the interpretation applied to the OID Regulations applicable to Publicly Traded CPDIs, Reorganized CFGI may be required to amend this schedule from time to time to reflect, among other things, payments or nonpayments of certain amounts. A holder of A Notes or B Notes is generally required to report accrual of OID and adjustments in a manner consistent with Reorganized CFGI's schedule of projected payments. A holder that chooses to use an inconsistent schedule of projected payments must expressly disclose such fact to the IRS, together with an explanation of why the holder set its own schedule, on the holder's U.S. federal income tax return for the taxable year that includes the acquisition of the A Notes or B Notes. The projected payment schedule and any amendments thereto can be obtained once the Notes are issued by submitting a written request to the Capmark Tax Director at Capmark Financial Group Inc., 116 Welsh Road, Horsham, Pennsylvania, 19044.

If, during any taxable year, a holder receives actual contingent payments with respect to the A Notes or B Notes that are in the aggregate more than the total amount of projected contingent payments for the A Notes or B Notes, respectively, with respect to that taxable year, the holder will incur a net positive adjustment for the taxable year equal to the amount of such excess. A net positive adjustment will be treated as additional OID in that taxable year.

If, during any taxable year, a holder receives actual contingent payments with respect to the A Notes or B Notes that are in the aggregate less than the contingent amounts reflected in the projected payment schedule for the A Notes or B Notes, respectively, with respect to that taxable year, the holder will incur a net negative adjustment for that taxable year equal to the amount of such deficit. A net negative adjustment will first reduce the amount of OID required to be accrued in that taxable year, and any excess will be treated as ordinary loss to the extent that the total prior net OID included in income with respect to the applicable Notes (taking into account the adjustments described above) exceeds the total amount of the holder's net negative adjustments treated as ordinary loss on the applicable Notes in prior taxable years. Any remaining net negative adjustment generally will be carried forward as a negative adjustment to the next succeeding taxable year.

If, as discussed above, the projected payment schedule is amended, the amendment may result in positive or negative adjustments to holders.

The OID Regulations applicable to Publicly Traded CPDIs are reserved with respect to the treatment of certain timing contingencies, including those related to prepayments. Accordingly, there is some uncertainty as to the application of the OID Regulations to timing contingencies such as prepayments on the Notes. Application of the rules in the OID Regulations described above to prepayments on the Notes may lead to distortive noneconomic results with potentially significant adverse tax consequences to holders and/or Reorganized CFGI. CFGI Holders are strongly urged to consult their tax advisors as to the application and effect of the OID Regulations to the reporting of income with respect to the A Notes and B Notes received by them.

b. *Market Discount, Acquisition Premium, Amortizable Bond Premium and Special Elections to Report Interest*

Special rules apply under the Tax Code if a holder has "market discount," "acquisition premium," or "amortizable bond premium" with respect to a debt instrument. These rules generally do not apply to debt instruments that are subject to the OID Regulations governing CPDIs. Also, in certain circumstances a holder of a debt instrument may elect to include all interest that accrues on a debt instrument in gross income on a constant yield basis, including any stated interest, OID, market discount, and unstated interest, as adjusted by any amortizable bond premium or acquisition premium. These rules are complex, subject to limitations, and, in certain respects, unclear. CFGI Holders should consult their tax advisors as to the application and effect of these rules in their particular circumstances to the reporting of income with respect to the A Notes and B Notes received by them.

c. *Sale, Exchange, or Disposition of Notes*

On the sale, exchange, or other disposition of A Notes or B Notes to which the CPDI rules apply, a holder of the A Notes or B Notes will generally recognize gain or loss equal to the difference between (i) the amount realized on such disposition reduced by any net negative adjustment carryforwards (as discussed above) and (ii) the holder's tax basis as of the Effective Date, increased by the OID previously accrued by the holder (determined without regard to any net positive or net negative adjustments to OID inclusions), and decreased by the amount of any noncontingent payments and the amount shown on the projected payment schedule of any contingent payment previously made on the Notes (without regard to the actual amount paid).

In general, any gain recognized by a holder upon the sale, exchange, or other disposition of the A Notes or B Notes will be treated as interest income. Any loss recognized upon the sale, exchange, or other disposition of the A Notes or B Notes generally will be treated as an ordinary loss to the extent that the net amount of OID the holder previously included in income with respect to the applicable Notes (taking into account the adjustments described above) exceeds the total amount of the holder's net negative adjustments treated as ordinary loss on the applicable Notes and thereafter as a capital loss.

4. Information Reporting and Backup Withholding

Payments under the Plan in respect of Allowed General Unsecured Claims, and payments made in respect of the Reorganized CFGI Debt Securities, may be subject to applicable information reporting and backup withholding (at the applicable rate). Backup withholding of taxes generally will apply to payments in respect of an Allowed General Unsecured Claim under the Plan, and payments made in respect of the Reorganized CFGI Debt Securities, if the holder of the claim or security fails to timely provide a taxpayer identification number or otherwise fails to comply with the applicable requirements of the backup withholding rules. Backup withholding is not an additional tax but merely an advance payment that may be refunded to the extent it results in an overpayment of tax, provided that the required information is provided to the IRS.

D. <u>Treatment of the Disputed Claims Reserve</u>

The Disputed Claims Reserve is intended to be treated, for U.S. federal income tax purposes, as a disputed ownership fund within the meaning of Treasury Regulations section 1.468B-9(b)(1). If so treated, any payment made out of the Disputed Claims Reserve should not be deemed to have been made to any recipient until, and to the extent that, the amount to which the recipient is entitled has been determined and distributed. At such time, the recipient will take such amount into account for

U.S. federal income tax purposes. Recipients of amounts from the Disputed Claims Reserve should report consistently with the foregoing and should consult their tax advisors concerning the federal, state, local, and other tax consequences of the receipt of amounts from the Disputed Claims Reserve and the consequences of owning and disposing of Reorganized CFGI Debt Securities and Reorganized CFGI Common Stock received from the Disputed Claims Reserve.

The Disputed Claims Reserve generally will treat a distribution of property in respect of Disputed Claims as a sale or exchange of such property for purposes of section 1001(a) of the Tax Code. Any income realized by the Disputed Claims Reserve (including with respect to any appreciation in the value of Reorganized CFGI Common Stock and Reorganized CFGI Debt Securities while held by the Disputed Claims Reserve) will be reported by the Disbursing Agent as income of and taxable to the Disputed Claims Reserve.

THE FOREGOING SUMMARY IS PROVIDED FOR GENERAL INFORMATIONAL PURPOSES ONLY. HOLDERS OF CLAIMS ARE STRONGLY URGED TO CONSULT THEIR OWN TAX ADVISORS REGARDING FEDERAL, STATE, LOCAL, AND NON-U.S. TAX CONSEQUENCES OF THE PLAN TO THEM.

XII. SECURITIES LAW MATTERS

In connection with the Plan, pursuant to section 1145 of the Bankruptcy Code, and except as provided in subsection (b) thereof, any issuance of the Reorganized CFGI Debt Securities and the shares of Reorganized CFGI Common Stock issued pursuant to the Plan shall be exempt from registration pursuant to section 4 of the Securities Act,[25] and all other applicable non-bankruptcy laws or regulations.

A. Issuance and Resale of New Securities

The issuance of the Reorganized CFGI Debt Securities and Reorganized CFGI Common Stock pursuant to the Plan is being made pursuant to the exemption available under section 1145 of the Bankruptcy Code. Subsequent transfers of the Reorganized CFGI Debt Securities and Reorganized CFGI Common Stock by holders thereof that are not "underwriters," as defined in section 2(a)(11) of the Securities Act and in the Bankruptcy Code, will be exempt from federal and state securities registration requirements under various provisions of the Securities Act, the Bankruptcy Code, and state securities laws.

Section 1145(a) of the Bankruptcy Code generally exempts from such registration requirements the issuance of securities if the following conditions are satisfied:

(a) the securities are issued or sold under a chapter 11 plan by (a) a debtor, (b) one of its affiliates participating in a joint plan with the debtor, or (c) a successor to a debtor under the plan and

(b) the securities are issued entirely in exchange for a claim against or interest in the debtor or such affiliate, or are issued principally in such exchange and partly for cash or property.

[25] The current form of the Securities Act, as amended through P.L. 111-229 and approved August 11, 2010, describes exempted transactions in section 4, but the Bankruptcy Code has not revised its reference to the amended Securities Act, which references section 5 of the Securities Act.

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UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re	)	Chapter 11
CHARTER COMMUNICATIONS, INC., et al.,[1]	)	Case No. 09-11435 (JMP)
Debtors.	)	Jointly Administered

DEBTORS' DISCLOSURE STATEMENT PURSUANT TO CHAPTER 11 OF THE BANKRUPTCY CODE WITH RESPECT TO THE DEBTORS' JOINT PLAN OF REORGANIZATION

THIS IS NOT A SOLICITATION OF ACCEPTANCE OR REJECTION OF THE PLAN. ACCEPTANCES OR REJECTIONS MAY NOT BE SOLICITED UNTIL A DISCLOSURE STATEMENT HAS BEEN APPROVED BY THE BANKRUPTCY COURT. THIS DISCLOSURE STATEMENT IS BEING SUBMITTED FOR APPROVAL BUT HAS NOT BEEN APPROVED BY THE BANKRUPTCY COURT. THE INFORMATION IN THIS DISCLOSURE STATEMENT IS SUBJECT TO CHANGE. THIS DISCLOSURE STATEMENT IS NOT AN OFFER TO SELL ANY SECURITIES AND IS NOT SOLICITING AN OFFER TO BUY ANY SECURITIES.

KIRKLAND & ELLIS LLP
Citigroup Center
153 East 53rd Street
New York, New York 10022-4611
Telephone: (212) 446-4800
Facsimile: (212) 446-4900
Richard M. Cieri
Paul M. Basta
Stephen E. Hessler

KIRKLAND & ELLIS LLP
200 East Randolph Drive
Chicago, Illinois 60601-6636
Telephone: (312) 861-2000
Facsimile: (312) 851-2200
Ray C. Schrock

Counsel to the Debtors and Debtors in Possession (other than Charter Investment, Inc.)

TOGUT, SEGAL & SEGAL LLP
One Penn Plaza
New York, New York 10119
Telephone: (212) 594-5000
Facsimile: (212) 967-4258
Albert Togut
Frank A. Oswald

Counsel to the Debtor and Debtor in Possession Charter Investment, Inc.

[1] The Debtors in these cases include: Ausable Cable TV, Inc.; Hometown TV, Inc.; Plattsburgh Cablevision, Inc.; Charter Communications Entertainment, LLC; Falcon First Cable of New York, Inc.; Charter Communications, Inc.; Charter Communications Holding Company, LLC; CCHC, LLC; Charter Communications Holdings, LLC; CCH I Holdings, LLC; CCH I, LLC; CCH II, LLC; CCO Holdings, LLC; Charter Communications Operating, LLC; American Cable Entertainment Company, LLC; Athens Cablevision, Inc.; Cable Equities Colorado, LLC; Cable Equities of Colorado Management Corp.; CC 10, LLC; CC Fiberlink, LLC; CC Michigan, LLC; CC Systems, LLC; CC V Holdings, LLC; CC VI Fiberlink, LLC; CC VI Operating, LLC; CC VII Fiberlink, LLC; CC VIII Fiberlink, LLC; CC VIII Holdings, LLC; CC VIII Leasing of Wisconsin, LLC; CC VIII Operating, LLC; CC VIII, LLC; CCH I Capital Corp.; CCH I Holdings Capital Corp.; CCH II Capital Corp.; CCO Fiberlink, LLC; CCO Holdings Capital Corp.; CCO NR Holdings, LLC; CCO Purchasing, LLC; Charter Advertising of Saint Louis, LLC; Charter Cable Leasing of Wisconsin, LLC; Charter Cable Operating Company, L.L.C.; Charter Cable Partners, L.L.C.; Charter Communications Entertainment I, DST; Charter Communications Entertainment I, LLC; Charter Communications Entertainment II, LLC; Charter Communications Holdings Capital Corporation; Charter Communications Operating Capital Corp.; Charter Communications Properties LLC; Charter Communications V, LLC; Charter Communications Ventures, LLC; Charter Communications VI, LLC; Charter Communications VII, LLC; Charter Communications, LLC; Charter Distribution, LLC; Charter Fiberlink – Alabama, LLC; Charter Fiberlink AR-CCVII, LLC; Charter Fiberlink AZ-CCVII, LLC; Charter Fiberlink CA-CCO, LLC; Charter Fiberlink CA-CCVII, LLC; Charter Fiberlink CC VIII, LLC; Charter Fiberlink CCO, LLC; Charter Fiberlink CT-CCO, LLC; (continued on next page)

Certain U.S. Federal Income Tax Consequences Of The Plan

The following is a summary of certain U.S. federal income tax consequences of the Plan to the Reorganized Company and Holders of Allowed Claims. This summary is based on the IRC, Treasury Regulations thereunder, and administrative and judicial interpretations and practice, all as in effect on the date of the Disclosure Statement and all of which are subject to change, with possible retroactive effect. Due to the lack of definitive judicial and administrative authority in a number of areas, substantial uncertainty may exist with respect to some of the tax consequences described below. No opinion of counsel has been obtained as to any of the tax consequences of the Plan discussed below. Although the Debtors intend to seek a private letter ruling from the IRS as to certain aspects of the Plan, the scope of the intended ruling is narrow and will not address most of the tax consequences of the Plan discussed below. There can be no assurance that the IRS will not challenge one or more of the tax consequences of the Plan described below.

This summary does not apply to Holders of Allowed Claims that are not "United States persons" (as such term is defined in the IRC) or that are otherwise subject to special treatment under U.S. federal income tax law (including, for example, banks, governmental authorities or agencies, financial institutions, insurance companies, pass-through entities, tax-exempt organizations, brokers and dealers in securities, mutual funds, small business investment companies, and regulated investment companies). The following discussion assumes that Holders of Allowed Claims hold such Claims as "capital assets" within the meaning of section 1221 of the IRC. Moreover, this summary does not purport to cover all aspects of U.S. federal income taxation that may apply to the Debtors and Holders of Allowed Claims based upon their particular circumstances. Additionally, this summary does not discuss any tax consequences that may arise under any laws other than U.S. federal income tax law, including under state, local, or foreign tax law.

The following summary is not a substitute for careful tax planning and advice based on the particular circumstances of each Holder of a Claim. Each Holder of a Claim is urged to consult his, her, or its tax advisors with respect to the U.S. federal income tax consequences, as well as other tax consequences, including under any applicable state, local, and foreign law, of the restructuring described in the Plan. This discussion does not address special consideration that may be applicable to Holders holding more than one class of Claims. Such Holders should consult their tax advisors with respect to their particular circumstances.

IRS Circular 230 Disclosure: To ensure compliance with requirements imposed by the IRS, any tax advice contained in this Disclosure Statement is not intended or written to be used, and cannot be used, by any taxpayer for the purpose of avoiding tax-related penalties under the IRC. The tax advice contained in this Disclosure Statement was written to support the promotion or marketing of the transactions described in this Disclosure Statement. Each taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

Certain U.S. Federal Income Tax Consequences to Reorganized Company

Cancellation of Debt and Reduction of Tax Attributes

In general, absent an exception, a debtor will realize and recognize cancellation of debt income ("COD Income") upon satisfaction of its outstanding indebtedness for total consideration less than the amount of such indebtedness. The amount of COD Income, in general, is the excess of (a) the adjusted issue price of the indebtedness satisfied over (b) the sum of (x) the amount of cash paid and (y) the fair market value of any new consideration (including stock of the debtor) given in satisfaction of such indebtedness at the time of the exchange.

A debtor will not, however, be required to include any amount of COD Income in gross income if the debtor is under the jurisdiction of a court in a case under Chapter 11 of the Bankruptcy Code and the discharge of debt occurs pursuant to that proceeding. Instead, as a consequence of such exclusion, a debtor must reduce its tax attributes by the amount of COD Income that it excluded from gross income under section 108 of the IRC. In general, tax attributes will be reduced in the following order: (a) NOLs; (b) most tax credits and capital loss carryovers; (c) tax basis in assets; and (d) foreign tax credits. A debtor with COD Income may elect first to reduce the basis of its depreciable assets under section 108(b)(5) of the IRC.

As a result of the Plan, the Debtors' aggregate existing indebtedness will be substantially reduced and the Reorganized Company will therefore have COD Income, which will be excluded from gross income under the rules discussed above. Because the Plan provides that Holders of certain Allowed Claims will receive New Class A Stock, the amount of COD Income, and accordingly the amount of tax attributes required to be reduced, will depend on the fair market value of the New Class A Stock exchanged therefor. This value cannot be known with certainty until after the Effective Date. However, the Debtors expect that, subject to the limitations discussed herein, the Reorganized Company will continue to have significant NOL carryovers and certain other tax attributes remaining after emergence.

A recently enacted amendment to the COD Income rules provides that taxpayers, including taxpayers operating under the jurisdiction of a court in a case under Chapter 11 of the Bankruptcy Code, that recognize COD Income in 2009 or 2010 may elect to forgo the COD Income exclusion and attribute reduction rules described above. Instead, the taxpayer may elect to take into taxable income the COD Income with respect to such debt in equal installments in 2014 through 2018 (i.e., the taxpayer would report 20% of the COD Income in each such year). This election to defer COD Income is made separately with respect to each debt instrument on which COD Income is realized, must be made on the taxpayer's tax return for the year that includes the transaction that creates the COD Income, and, in the case of debt of a partnership, is made at the partnership level. The Debtors do not intend to elect to apply this new rule.

Because of the unique organizational structure of the Debtors, most of the COD Income that will be generated from the Plan will occur at Holdco and its subsidiaries (which are generally disregarded entities for U.S. federal income tax purposes). This COD Income will be allocated to the two members of Holdco (CCI and CII) based on their respective percentage ownership interests in Holdco. The Debtors expect that this means that approximately 54% of the COD Income will be allocated to CCI and 46% to CII. This allocation formula is one of the principal tax reasons for retaining the Holdco structure, since the allocation of COD income to CII is expected to result in several billion dollars of NOL carryforwards being preserved at the CCI level. If Holdco were dissolved or liquidated before the Effective Date, all of the COD Income could potentially be allocated to CCI, thereby eliminating most of CCI's NOL carryforwards. There is therefore a material tax benefit to the Debtors of preserving the existing Holdco structure. The Allen Entities have the right post-Effective Date to exchange their interest in Holdco for CCI, but the Allen Entities are under no obligation to do so and it is uncertain whether they will do so.

Under the U.S. federal income tax rules dealing with COD Income, the tax treatment of that income will be determined with respect to each of CCI and CII at the member level. Because CCI is in bankruptcy, COD income allocated to CCI will not be included in income, but it will result in a reduction in CCI's NOL carryforwards after the Effective Date. Because CCI is primarily just a holding company, the NOL carryforwards that will be preserved at CCI will generally be usable only to the extent that Holdco and the direct and indirect subsidiaries of Holdco have taxable income in the future; such NOL carryforwards would not have any future value to CCI if CCI were not to reorganize in a Chapter 11 proceeding,. And because of the "ownership change" limitations discussed below, it is generally the case that any NOL carryforwards at CCI could not be utilized by CCI if CCI were a standalone company without its ownership interest in Holdco and Holdco's subsidiaries.

Limitation of Net Operating Loss Carryforwards and Other Tax Attributes

The precise amount of the NOL carryforwards and other tax attributes that will be available to the Reorganized Company at emergence is based on a number of factors and is impossible to calculate at this time. Some of the factors that will impact the amount and utilization of the NOLs include the following: (a) the amount of tax losses incurred by the Debtors through emergence; (b) the value of the New Class A Stock; (c) the amount of COD Income incurred by the Debtors in connection with the Effective Date; and (d) the allocation of COD Income between CII and CCI.

Following the Effective Date, the Debtors anticipate that any remaining NOL and tax credit carryovers and, possibly, certain other tax attributes of the Reorganized Company allocable to periods prior to and including the Effective Date (collectively, "Pre-Change Losses") will be subject to a limitation under section 382 of the IRC as a result of an "ownership change" of CCI by reason of the transactions pursuant to the Plan. Under section 382 of the IRC, if a corporation undergoes an "ownership change," the amount of its Pre-Change Losses that may be utilized to offset future taxable income generally is subject to an annual limitation. As discussed more fully below, the Debtors anticipate that the issuance of the New Class A Stock pursuant to the Plan will result in an "ownership change" of

CCI for these purposes and that the Reorganized Company's use of its NOL carryovers will be subject to limitation unless an exception to the general rules of section 382 of the IRC applies.

General Section 382 Annual Limitation

In general, the amount of the annual limitation to which a corporation that undergoes an "ownership change" would be subject is equal to the product of (i) the fair market value of the stock of the corporation immediately before the "ownership change" (with certain adjustments) and (ii) the "long-term tax-exempt rate" in effect for the month in which the "ownership change" occurs (4.61% for ownership changes occurring in May 2009). Any unused limitation may be carried forward, thereby increasing the annual limitation in the subsequent taxable year. Additionally, if the assets of a corporation experiencing an ownership change have a fair market value greater than their tax basis (a "net unrealized built-in gain"), the corporation is permitted to increase its annual section 382 limitation during the five years immediately after the "ownership change" by an amount equal to the depreciation deductions that a hypothetical purchaser of the corporation's assets would have been permitted to claim if it had acquired the corporation's assets in a taxable transaction. Additionally, Section 383 of the IRC applies a similar limitation to capital loss carryforwards and tax credits. The Debtors expect to request a private letter ruling from the IRS respecting the methodology by which the annual limitation after an ownership change should be calculated. Due to the Debtors' organizational structure, the calculation of such limitation amount is unusually complex and thus the Debtors have determined it would be appropriate to seek an IRS ruling.

Special Bankruptcy Exceptions

An exception to the foregoing annual limitation rules generally applies when so-called "qualified creditors" and continuing shareholders of a debtor company in Chapter 11 receive, in respect of their claims, at least 50% of the vote and value of the stock of the reorganized debtor (or a controlling corporation if also in Chapter 11) pursuant to a confirmed Chapter 11 plan (the "382(l)(5) Exception"). Under the 382(l)(5) Exception, a debtor's Pre-Change Losses are not limited on an annual basis but, instead, are required to be reduced by the amount of any interest deductions claimed during the three taxable years preceding the effective date of the plan of reorganization, and during the part of the taxable year prior to and including the effective date of the plan of reorganization, in respect of all debt converted into stock in the reorganization. If the 382(l)(5) Exception applies and a debtor undergoes another ownership change within two years the debtor's Pre-Change Losses effectively would be eliminated in their entirety.

Where the 382(l)(5) Exception is not applicable (either because the debtor does not qualify for it or the debtor elects not to utilize the 382(l)(5) Exception), a second special rule will generally apply (the "382(l)(6) Exception"). When the 382(l)(6) Exception applies, a debtor corporation that undergoes an "ownership change" generally is permitted to determine the fair market value of its stock after taking into account the increase in value resulting from any surrender or cancellation of creditors' claims in the bankruptcy. This differs from the ordinary rule that requires the fair market value of a debtor corporation that undergoes an "ownership change" to be determined before the events giving rise to the change. The 382(l)(6) Exception also differs from the 382(l)(5) Exception in that (i) the debtor corporation is not required to reduce its NOLs by the amount of interest deductions claimed within the prior three-year period and (ii) the debtor may undergo another ownership change within two years without triggering the elimination of its NOLs. Whether a debtor takes advantage of the 382(l)(5) Exception or the 382(l)(6) Exception, the debtor's use of the Pre-Change Losses may be adversely affected if the debtor were to undergo another ownership change.

The Debtors believe that the CCI ownership change resulting from the Effective Date is unlikely to qualify for the 382(l)(5) Exception. Accordingly, the Debtors expect that the use of the Reorganized Company's NOL carryforwards will be subject to limitation based on the rules discussed above, but taking into account the 382(l)(6) Exception. The exact amount of the benefits from the application of the 382(l)(6) Exception in these circumstances is not entirely clear, because the amount of such benefits will depend primarily on the value inherent in Holdco and its subsidiaries and the methodology by which such value is determined. Accordingly, the Debtors intend to request a private letter ruling from the IRS with respect to the application of the 382(l)(6) Exception to the ownership change arising from Effective Date. Further, while the Debtors' analysis continues, they believe the Reorganized Company may have a net unrealized built-in gain on its assets, and, accordingly, its ability to utilize its Pre-Change Losses to offset its taxable income under section 382 of the IRC following the Effective Date may be significantly enhanced.

Restrictions on Resale of Securities to Protect NOLs

The Debtors expect the Reorganized Company to emerge from Chapter 11 with valuable tax attributes, including NOL carryforwards. As discussed above, the Reorganized Company's ability to utilize these tax attributes could be subject to a greater limitation if another ownership change were to occur after emergence. To reduce the risk of an ownership change that might impose such a limitation, the Amended and Restated Certificate of Incorporation will include special provisions designed to permit the Board of Directors to impose certain restrictions on trading with respect to New Class A Stock. These special provisions are described above in "Important Aspects of the Plan — Other Provisions," which begins on page 31.

Alternative Minimum Tax

In general, an alternative minimum tax ("AMT") is imposed on a corporation's alternative minimum taxable income ("AMTI") each year at a 20% rate to the extent such tax exceeds the corporation's regular federal income tax for such year. AMTI is generally equal to regular taxable income with certain adjustments. For purposes of computing AMTI, certain tax deductions and other beneficial allowances are modified or eliminated. For example, even though for regular tax purposes a corporation might otherwise be able to offset all of its taxable income by NOL carryovers from prior years, only 90% of a corporation's AMTI may be offset by available alternative tax NOL carryforwards. This rule could cause certain Reorganized Debtors to owe federal and state income tax on taxable income in future years even though NOL carryforwards are available to offset regular taxable income.

Additionally, if a corporation undergoes an "ownership change" within the meaning of section 382 of the IRC, the section 382 rules discussed above also apply to its NOL carryforwards for AMT purposes. Any AMT tax that a corporation pays is generally allowed as a nonrefundable credit against its regular U.S. federal income tax liability in future taxable years to the extent that the corporation is no longer subject to AMT.

Certain U.S. Federal Income Tax Consequences to the Holders of Allowed Claims

For U.S. federal income tax purposes, nearly all of Holdco's direct and indirect subsidiaries are treated as "disregarded" entities. As a result, holders of Allowed Claims against those direct and indirect subsidiaries are treated as though they held claims against Holdco for U.S. federal income tax purposes. The discussion below generally assumes therefore that Holdco and each of its direct and indirect subsidiaries are treated as one company for these purposes.

Consequences to Holders of Allowed Secured Claims

Pursuant to the Plan, each Holder of an Allowed Secured Claim will either (i) have its Claim Reinstated, (ii) be paid in full in cash, or (iii) have all collateral securing such Claim returned.

If a Holder of an Allowed Secured Claim receives cash or has all collateral securing such Claim returned in satisfaction of its Claim, the satisfaction should be treated as a taxable exchange under section 1001 of the IRC. The Holder should recognize capital gain or loss (which capital gain or loss should be long-term capital gain or loss if the Holder has held its Claim for more than one year) (subject to the "market discount" rules described below) equal to the difference between (x) the amount of cash or the fair market value of other property received and (y) the Holder's adjusted tax basis in its Claim. To the extent that the cash or property received in the exchange is allocable to accrued interest that has not already been taken into income by the Holder, the Holder may recognize ordinary interest income. If an Allowed Secured Claim is Reinstated, the Holder of such Claim should not recognize gain or loss except to the extent collateral securing such Claim is changed and the change in collateral constitutes a "significant modification" of the Allowed Secured Claim within the meaning of the Treasury Regulations promulgated under section 1001 of the IRC.

Consequences to Holders of Allowed CCI Note Claims

Pursuant to the Plan, each Holder of an Allowed CCI Note Claim will receive its Pro Rata share of (i) shares of New Preferred Stock and (ii) cash in the amount determined under the Plan.

The U.S. federal income tax consequences to a Holder arising from the exchange of an Allowed CCI Note Claim for cash and New Preferred Stock will depend, in part, on whether the CCI Note Claims each constitute a "security" for U.S. federal income tax purposes. Whether a debt instrument constitutes a "security" is determined based on all the relevant facts and circumstances, but most authorities have held that the length of the term of a debt instrument is an important factor in determining whether such instrument is a security for U. S. federal income tax purposes. These authorities have indicated that a term of less than five years is evidence that the instrument is not a security, whereas a term of ten years or more is evidence that it is a security. There are numerous other factors that could be taken into account in determining whether a debt instrument is a security, including the security for payment, the creditworthiness of the obligor, the subordination or lack thereof to other creditors, the right to vote or otherwise participate in the management of the obligor, convertibility of the instrument into an equity interest of the obligor, whether payments of interest are fixed, variable or contingent, and whether such payments are made on a current basis or accrued. Each Holder of a Claim should consult with its tax advisor to determine whether or not the debt underlying such Claim is a "security" for U.S. federal income tax purposes.

If a Holder's Allowed CCI Note Claim constitutes a security for U.S. federal income tax purposes, the exchange of such Claim for cash and the New Preferred Stock should be characterized as a reorganization for U.S. federal income tax purposes. Holders of Allowed CCI Note Claims may be required to recognize gain, but not loss, on the exchange. Specifically, a Holder may recognize (a) capital gain, subject to the market discount rules discussed below, to the extent of the lesser of (i) the amount of gain realized on the exchange and (ii) the amount of cash received, and (b) gain or loss with respect to accrued interest, as described below. In such case, a Holder should obtain a tax basis in the New Preferred Stock equal to the tax basis of the surrendered CCI Note, increased by the amount of gain recognized and decreased by the amount of cash received; provided that the tax basis of any New Preferred Stock that is treated as received in satisfaction of accrued interest should equal the amount of such accrued interest. A Holder's holding period for its New Preferred Stock received should include such Holder's holding period for the surrendered CCI Note; provided that the holding period for any New Preferred Stock that is treated as received in satisfaction of accrued interest should begin on the day following the Effective Date.

If a Holder's Allowed CCI Note Claim does not constitute a security for U.S. federal income tax purposes, the exchange of such Claim for cash and the New Preferred Stock will constitute a taxable exchange under Section 1001 of the IRC. Accordingly, such Holder should recognize gain or loss equal to the difference between (1) the amount of cash received and the value of the New Preferred Stock received and (2) the Holder's adjusted basis in its Allowed CCI Note Claim. The character of such gain or loss as capital gain or loss or as ordinary income or loss will be determined by a number of factors, including the tax status of the Holder, the nature of the Claim in the Holder's hands, whether the Claim was purchased at a discount, the amount of accrued interest, and whether and to what extent the Holder has previously claimed a bad debt deduction with respect to its Claim. The U.S. federal income tax consequences of market discount and the receipt of cash allocable to accrued interest are summarized below. A Holder's basis in the New Preferred Stock will equal its fair market value as of the Effective Date, and a Holder's holding period for its New Preferred Stock will begin on the day following the Effective Date.

To the extent the Reorganized Company has positive earnings and profits for U.S. federal income tax purposes in the future, there is a risk that a holder of New Preferred Stock will be required to include in taxable income an amount equal to the accrued but unpaid yield on the New Preferred Stock, even if no dividends are paid in cash. The tax consequences of owning New Preferred Stock that does not pay a regular cash dividend is complex; holders of New Preferred Stock should consult their own tax advisor regarding such consequences.

Consequences to Holders of Allowed CCH Note Claims and Allowed CIH Note Claims

Pursuant to the Plan, each Holder of an Allowed CCH Note Claim or an Allowed CIH Note Claim will receive its Pro Rata share of Warrants to purchase shares of New Class A Stock in the aggregate amount determined under the Plan.

Holders of Allowed CCH Note Claims and Allowed CIH Note Claims may recognize gain or loss on the exchange of such Claims for Warrants to purchase New Class A Stock. Although certain of such Claims may constitute securities, the exchange of such Claims for Warrants to purchase New Class A Stock will not qualify as a tax-free reorganization because such Claims were issued by various subsidiaries of CCI and will be exchanged for equity in CCI. Accordingly, each Holder of such a Claim may recognize gain or loss equal to the difference between: (i) the fair market value of the Warrants to purchase New Class A Stock (as of the date the Warrants are

distributed to the Holder) received in exchange for the Claim and (ii) the Holder's adjusted basis in the Claim. Such gain or loss should be capital in nature so long as the Claim is held as a capital asset (subject to the "market discount" rules described below) and should be long-term capital gain or loss if the Claim was held for more than one year. To the extent that a portion of the Warrants received in exchange for a Claim is allocable to accrued but untaxed interest, the Holder may recognize ordinary income. A Holder's tax basis in the Warrants received should equal the fair market value of the Warrants as of the date distributed to the Holder, and a Holder's holding period for the Warrants should begin on the day following the Effective Date.

Consequences to Holders of Allowed CCH II Notes Claims

Pursuant to the Exchange, each Holder of an Allowed CCH II Note Claim will exchange such Holder's CCH II Note for one of the following: (i) a New CCH II Note, (ii) cash, or (iii) both a New CCH II Note and cash.

The U.S. federal income tax consequences of the exchange of a CCH II Note for a New CCH II Note will depend on whether the exchange results in a "significant modification" of the CCH II Note (i.e., whether the terms of the New CCH II Notes are significantly different from the terms of the CCH II Notes exchanged therefor). The Treasury Regulations under section 1001 of the IRC provide specific rules for determining whether certain modifications are "significant." One such rule provides that a change in the annual yield of an instrument will be considered "significant" if the modified rate varies from the original rate by more than the greater of (a) 25 basis points and (b) 5 percent of the annual yield of the unmodified instrument. Because the New CCH II Notes will bear an interest rate that exceeds the interest rate payable with respect to the CCH II Notes by more than such amount, the Exchange should result in a significant modification of the CCH II Notes. Therefore, the exchange of CCH II Notes for New CCH II Notes and/or cash should be a taxable exchange under section 1001 of the IRC.

A Holder who receives New CCH II Notes and/or cash with respect to an Allowed CCH II Note Claim will generally recognize income, gain or loss for U.S. federal income tax purposes in an amount equal to the difference between (a) the sum of (i) the fair market value of any New CCH II Notes received and (ii) the amount of any cash received and (b) the Holder's adjusted basis in its Allowed CCH II Note Claim. Such gain or loss may be capital in nature (subject to the "market discount" rules described below) and may be long-term capital gain or loss if the CCH II Notes were held for more than one year. To the extent that a portion of the cash or New CCH II Notes received represents accrued but unpaid interest that the Holder has not already taken into income, the Holder may recognize ordinary interest income. A Holder's tax basis in any New CCH II Notes received should equal the fair market value of the New CCH II Notes as of the date distributed to the Holder, and a Holder's holding period for the New CCH II Notes should begin on the day following the Exchange.

The tax consequences with respect to an exchange of CCH II Notes (including with respect to accrued but unpaid interest) are complex and each Holder of such notes should consult with its own tax advisor.

Consequences to Holders of Allowed CCH I Note Claims

Pursuant to the Plan, each Holder of an Allowed CCH I Note Claim will receive its Pro Rata share of New Class A Stock in the aggregate amount determined under the Plan. Additionally, certain Holders of Allowed CCH I Note Claims will also receive Rights pursuant to the Rights Offering.

Although certain of such Claims may constitute securities, the exchange of such Claims for New Class A Stock (and, with respect to certain Holders, Rights) will not qualify as a tax-free reorganization because such Claims were issued by various subsidiaries of CCI and will be exchanged for equity in CCI.

A Holder of an Allowed CCH I Note Claim will generally recognize income, gain or loss for U.S. federal income tax purposes in an amount equal to the difference between (a) the sum of (i) the fair market value of the New Class A Stock received and (ii) the fair market value of any Rights received, and (b) the Holder's adjusted basis in its Allowed CCH I Note Claim. Such gain or loss should be capital in nature (subject to the "market discount" rules described below) and should be long-term capital gain or loss if the CCH I Note was held for more than one year. To the extent that a portion of the New Class A Stock received represents accrued but unpaid interest that the Holder has not already taken into income, the Holder may recognize ordinary interest income. A Holder's basis in its New Class A Stock will equal its fair market value as of the Effective Date, and a Holder's holding period for its New Class A Stock will begin on the day following the Effective Date.

Consequences to Holders of New CCH II Notes

Stated interest on the New CCH II Notes will generally be taxable to a holder of New CCH II Notes as ordinary income at the time the interest is paid or accrues in accordance with the holder's method of accounting for U.S. federal income tax purposes. A holder of New CCH II Notes generally will be required to report the excess of the stated principal amount of the New CCH II Notes over the issue price of the New CCH II Notes as original issue discount on the New CCH II Notes on a constant yield basis over the term of the New CCH II Notes.

A holder will generally recognize capital gain or loss upon the sale, exchange, redemption or other taxable disposition of a New CCH II Note equal to the difference between the amount realized (less any accrued but unpaid interest, which generally will be taxable as such) and the holder's adjusted tax basis in the note. A noncorporate holder who has held the note for more than one year generally will be subject to reduced rates of taxation on such gain. The ability to deduct capital losses may be limited.

Consequences to Participants in the Rights Offering

A holder of Rights generally should not recognize taxable gain or loss upon the exercise of such Rights. The tax basis in the New Class A Stock received upon exercise of the Rights should equal the sum of the holder's tax basis in the Rights and the amount paid for such New Class A Stock. The holding period in such New Class A Stock received should commence the day following its acquisition.

Accrued But Untaxed Interest

A portion of the consideration (whether cash, stock, debt or other consideration) received by Holders of Claims and Interests may be attributable to accrued but untaxed interest on such Claims. Such amount should be taxable to that Holder as interest income if such accrued interest has not been previously included in the Holder's gross income for U.S. federal income tax purposes. Conversely, a holder generally recognizes a deductible loss to the extent any accrued interest claimed was previously included in income and is not paid in full.

If the fair value of the consideration received by Holders of Claims and Interests is not sufficient to fully satisfy all principal and interest on Allowed Claims, the extent to which such consideration will be attributable to accrued but untaxed interest is unclear. Holders of Claims and Interests should consult their tax advisors regarding the proper allocation of the consideration received by them under the Plan.

Market Discount

As indicated above, certain Holders of Allowed Claims may be affected by the "market discount" provisions of sections 1276 through 1278 of the IRC. Under these rules, some or all of the gain realized by a Holder may be treated as ordinary income (instead of capital gain) to the extent of the amount of accrued "market discount" on such Holder's Allowed Claim.

In general, a debt obligation with a fixed maturity of more than one year that is acquired by a holder on the secondary market (or, in certain circumstances, upon original issuance) is considered to be acquired with "market discount" as to that holder if the debt obligation's stated redemption price at maturity (or revised issue price as defined in section 1278 of the IRC, in the case of a debt obligation issued with original issue discount) exceeds the tax basis of the debt obligation in the holder's hands immediately after its acquisition. However, a debt obligation is not a "market discount bond" if such excess is less than a statutory de minimis amount (equal to 0.25 percent of the debt obligation's stated redemption price at maturity or revised issue price, in the case of a debt obligation issued with original issue discount, multiplied by the number of complete years remaining until maturity at the time of the acquisition).

Any gain recognized by a Holder on the taxable disposition of an Allowed Claim (determined as described above) that was acquired with market discount should be treated as ordinary income to the extent of the market discount that accrued thereon while the Allowed Claim was considered to be held by the Holder (unless the Holder elected to include market discount in income as it accrued). To the extent that any Allowed Claims that were acquired with market discount are exchanged in a tax-free transaction for other property, any market discount that accrued on the Allowed Claims (i.e., up to the time of the exchange) but was not recognized by the Holder is carried

over to the property received therefore, and any gain recognized on a subsequent sale, exchange, redemption or other disposition of such property is treated as ordinary income to the extent of such accrued market discount.

Information Reporting and Backup Withholding

In general, information reporting requirements may apply to distributions or payments under the Plan. Additionally, under the backup withholding rules, a Holder of a Claim may be subject to backup withholding (currently at a rate of 28%) with respect to distributions or payments made pursuant to the Plan unless that Holder: (a) comes within certain exempt categories (which generally include corporations) and, when required, demonstrates that fact; or (b) provides a correct taxpayer identification number and certifies under penalty of perjury that the taxpayer identification number is correct and that the Holder is not subject to backup withholding because of a failure to report all dividend and interest income. Backup withholding is not an additional tax, but merely an advance payment that may be refunded to the extent it results in an overpayment of tax, provided that the required information is provided to the IRS.

The Debtors will withhold all amounts required by law to be withheld from payments of interest. The Debtors will comply with all applicable reporting requirements of the IRC.

The U.S. federal income tax consequences of the Plan are complex. The foregoing summary does not discuss all aspects of U.S. federal income taxation that may be relevant to a particular Holder of a Claim in light of such Holder's circumstances and income tax situation. All Holders of Claims against the Debtors should consult with their tax advisors as to the particular tax consequences to them of the transactions contemplated by the restructuring, including the applicability and effects of any state, local, or foreign tax laws, and any change in applicable tax laws.

John P. Schafer (State Bar No. 205638)
jps@mandersonllp.com
Chris Manderson (State Bar No. 211648)
wcm@mandersonllp.com
Lance A. McKinlay (State Bar No. 213717)
lam@mandersonllp.com
MANDERSON, SCHAFER & McKINLAY LLP
4695 MacArthur Court, Suite 1270
Newport Beach, CA 92660
Telephone: (949) 788-1038
Facsimile: (949) 743-8310

Attorneys for SIGNATURE GROUP HOLDINGS LLC

UNITED STATES BANKRUPTCY COURT

CENTRAL DISTRICT OF CALIFORNIA

SANTA ANA DIVISION

BY FAX

In re:

FREMONT GENERAL CORPORATION, a Nevada corporation, Debtor. Taxpayer ID No. 95-2815260	Case No. 8:08-bk-13421-ES Chapter 11 Case **DISCLOSURE STATEMENT FOR SIGNATURE GROUP HOLDINGS LLC'S CHAPTER 11 PLAN OF REORGANIZATION OF FREMONT GENERAL CORPORATION DATED DECEMBER 3, 2009**

ORIGINAL

Act, as amended), asset composition (including diversification and industry concentration), governance, capital structure and use of leverage.

G. Tax Consequences of Plan

1. **Certain Federal Income Tax Consequences of the Signature Plan**

TO ENSURE COMPLIANCE WITH U.S. TREASURY DEPARTMENT CIRCULAR 230, HOLDERS OF CLAIMS AND EQUITY INTERESTS ARE HEREBY NOTIFIED THAT:

(A) ANY DISCUSSION OF U.S. FEDERAL TAX ISSUES CONTAINED OR REFERRED TO IN THIS DISCLOSURE STATEMENT IS NOT INTENDED OR WRITTEN TO BE RELIED UPON, AND CANNOT BE RELIED UPON, BY SUCH HOLDERS FOR THE PURPOSE OF AVOIDING PENALTIES THAT MAY BE IMPOSED ON THEM UNDER THE INTERNAL REVENUE CODE OF 1986, AS AMENDED ("TAX CODE");

(B) SUCH DISCUSSION IS WRITTEN IN CONNECTION WITH THE PROMOTION OR MARKETING OF THE TRANSACTION OR MATTERS ADDRESSED HEREIN; AND

(C) SUCH HOLDERS SHOULD SEEK ADVICE BASED ON THEIR PARTICULAR CIRCUMSTANCES FROM THEIR OWN INDEPENDENT TAX ADVISOR.

a) General

The following discussion is a summary of certain U.S. federal income tax consequences of the Signature Plan to the Debtor and to holders of Claims and Equity Interests. This discussion is based on the Internal Revenue Code of 1986, as amended (the "Code"), Treasury regulations promulgated and proposed thereunder (the "Treasury regulations"), judicial decisions and published administrative rules and pronouncements of the Internal Revenue Service (the "IRS") as in effect on the date hereof.

Due to the complexity of certain aspects of the Signature Plan, the lack of applicable

legal precedent for many of the federal tax consequences of the Signature Plan, the possibility of changes in the law, the potential for disputes as to legal and factual matters with the IRS, the federal tax consequences described in the Signature Plan are subject to significant uncertainties and may or may not reflect the position taken by the Debtor on any tax return. No legal opinions have been requested from counsel with respect to any of the tax aspects of the Signature Plan and no rulings have been or will be requested from the IRS with respect to the any of the issues discussed below. Furthermore, legislative, judicial or administrative changes may occur, perhaps with retroactive effect, that could affect the accuracy of the statements and conclusions set forth below as well as the tax consequences to the Debtor and the holders of Claims and Equity Interests.

This discussion does not purport to address all aspects of U.S. federal income taxation that may be relevant to the Debtor or the holders of Claims or Equity Interests in light of their personal circumstances, nor does the discussion deal with tax issues with respect to taxpayers subject to special treatment under the U.S. federal income tax laws (including, for example, banks, governmental authorities or agencies, pass-through entities, brokers and dealers in securities who elect to apply a mark-to-market method of accounting, insurance companies, financial institutions, tax-exempt organizations, small business investment companies, regulated investment companies, foreign taxpayers, and persons who hold Claims as part of a "straddle," a "hedge against currency risk or a "conversion transaction"). Except as expressly set forth below, no aspect of foreign, state, local or estate and gift taxation is addressed.

No assurance can be given as to the positions that the Debtor and its subsidiaries may take in any tax returns, or as to the amount of the Debtor's net operating losses ("NOLs") or other tax attributes. This discussion includes certain financial projections and estimates based on preliminary information that is subject to further review. No assurance can be given that actual results will not differ materially.

THE FOLLOWING SUMMARY IS NOT A SUBSTITUTE FOR CAREFUL TAX

PLANNING AND ADVICE BASED UPON THE PERSONAL CIRCUMSTANCES OF EACH HOLDER OF A CLAIM OR EQUITY INTEREST. THERE CAN BE NO ASSURANCE THAT THE IRS WILL NOT CHALLENGE ANY OF THE TAX CONSEQUENCES DESCRIBED HEREIN, OR THAT SUCH A CHALLENGE, IF ASSERTED, WOULD NOT BE SUSTAINED. ACCORDINGLY, EACH HOLDER OF A CLAIM OR EQUITY INTEREST IS URGED TO CONSULT WITH SUCH HOLDER'S TAX ADVISORS CONCERNING THE U.S. FEDERAL, STATE, LOCAL, FOREIGN AND OTHER TAX CONSEQUENCES OF THE SIGNATURE PLAN.

b) Consequences to Debtor Group

(i) Mergers of FGCC and FRC into the Debtor

Pursuant to the Signature Plan, each of FGCC and FRC would be merged into the Debtor in connection with effectiveness of the Signature Plan, but prior to, and as a condition to, the infusion of equity capital by Signature and the issuance of the Warrants. Each merger should be treated for U.S. federal income tax purposes as a liquidation of FGCC or FRC, as the case may be, into the Debtor. It is expected that each of FGCC and FRC will be solvent at the time of the merger and that each merger should be treated as a liquidation pursuant to Section 332.

(ii) Cancellation of Indebtedness

Under the Signature Plan, holders of Claims in the following classes will be paid the full amount of their Allowed Claims: Administrative Claims, Priority Taxes, Secured Claims, Priority Non-Tax Claims, General Unsecured Claims of the Holders of the 7.875% Senior Notes. Since those Claims will be paid in full, satisfaction of such Claims should not give rise to COD Income to the Debtor (except to the extent that interest previously accrued and deducted by the Debtor is not required to be paid). Similarly, the holders of General Unsecured Claims in Class 3A, the TOPrS Claims, the Junior Notes, the Equity Interests and the Section 510(b) Claims will not be impaired and, in certain cases, such Claims do not

relate to debt instruments, and therefore no COD Income should result from these Claims.

As noted above, the Debtor is the common parent of an affiliated group of corporations that join in the filing of a consolidated U.S. federal income tax return (the "Debtor Group"). The principal intercompany claim between the Debtor and its affiliates is an intercompany payable owed by the Debtor to FRC, the bulk of which is owed in connection with the Tax Allocation Agreement. The merger of FRC into the Debtor that will be consummated pursuant to the Signature Plan will result in the elimination of this intercompany claim. If, as expected, the liquidation of FRC into the Debtor is taxfree pursuant to Section 332, no discharge of indebtedness income should be recognized upon elimination of the intercompany claim.

As a result of the foregoing, the Debtor believes that it will not realize a material amount of COD Income for U.S. federal income tax purposes as a result of the implementation of the Signature Plan. The holders of Claims and Equity Interests should be advised that no ruling has been requested from the IRS regarding this issue and no assurances can be given that the positions intended to be taken by the Debtor will be accepted by the IRS.

(iii) Net Operating Losses

Based on information made available by the Debtor, as of December 31, 2008, the Debtor Group estimates that it had U.S. consolidated net operating losses of approximately $819 million. The Debtor has indicated that the amount of such NOLs remains subject to adjustment by the IRS, as well as to carrybacks to prior years to cover additional tax assessments in prior years depending upon the outcome of ongoing IRS examinations. As a result of the recent enactment of the *Worker, Homeownership, and Business Assistance Act of 2009* (H.R. 3548), signed into law by President Obama on November 6, 2009, Fremont General Corporation and its subsidiaries that join with it in filing a federal consolidated corporate income tax

return are now permitted to elect up to a five year carryback (instead of a two year carryback) of NOLs and alternative minimum tax NOLs ("AMT NOLs") incurred in 2008 or 2009. Fremont General Corporation intends to make such an election, and has determined that the carryback of its 2008 NOL and 2008 AMT NOL may result in tax refunds of approximately $20 million, although the exact amount and timing of any refunds remains uncertain. The carryback refund would be requested by filing Form 1139 and such filing would be subject to audit. After partial utilization of its 2008 NOL, Fremont General Corporation projects a NOL carryforward for the Fremont General Corporation consolidated group as of December 31, 2008 of approximately $769 million. In general, NOLs may be carried back two years and forward twenty years. The Reorganized Debtor's ability to utilize such NOLs may be limited by Section 382 of the Code, as described below.

c) Overview of Section 382

(1) Net Operating Losses. Under Section 382 of the Code, if a corporation with NOLs (a "loss corporation") undergoes an "ownership change," the amount of its pre-change NOLs that may be utilized to offset post-change taxable income is subject to an annual limitation (the "Section 382 Limitation"). In general terms, an "ownership change" will occur if one or more of the corporation's 5% shareholders increase their ownership, in the aggregate, by more than 50 percentage points over a three-year period. The Section 382 Limitation is an amount equal to the product of the applicable long-term tax-exempt rate in effect on the date of the ownership change (for example, 4.48% for ownership changes occurring in October 2009) and the value of the loss corporation immediately prior to the ownership change. The value of the loss corporation generally is equal to the value of the stock of the loss corporation immediately before the ownership change, provided that such value is subject to (i) reduction if the corporation will hold substantial non-business assets after the ownership change and (ii) certain other adjustments specified in Section 382 and applicable Treasury regulations. If a loss corporation does not continue its historic business or use a significant portion of its business assets in a new business for two years after the ownership change, the Section 382

Limitation would be zero. Generally, Section 382 and the Section 382 Limitation are applied to a consolidated group as though the group were a single corporation, subject to certain exceptions noted below.

(2) Built-in Losses. In addition to limiting a corporation's ability to utilize NOLs, the Section 382 Limitation may limit the use of certain losses or deductions which are "built-in" as of the date of an ownership change and which are subsequently recognized. If a loss corporation has a net unrealized built-in loss at the time of an ownership change in excess of a specified threshold (taking into account most assets and all items of "built-in" income and deduction), then any built-in loss or deduction recognized during the following five years (up to the amount of the original net built-in loss) generally will be treated as a pre-change loss and will be subject to the Section 382 Limitation. Conversely, if the loss corporation has a net unrealized built-in gain at the time of an ownership change, in excess of a specified threshold, then any built-in gain recognized during the following five years (up to the amount of the original net built-in gain) generally will increase the Section 382 Limitation in the year recognized, such that the loss corporation would be permitted to use prechange losses against such built-in gain income in addition to its regular annual allowance.

(3) Section 382(1)(5) Bankruptcy Exception. Section 382(1)(5) provides an exception to the application of the Section 382 Limitation for certain loss corporations under the jurisdiction of a court in a bankruptcy case (the "Section 382(1)(5) Bankruptcy Exception"). The Section 382(1)(5) Bankruptcy Exception applies if historic shareholders and certain creditors prior to an ownership change own at least 50 percent of the total voting power and total value of the loss corporation's stock after the ownership change (the "50 percent historic shareholder test"). The historic shareholders and creditors must own at least 50 percent of the corporation's stock as a result of being shareholders and creditors immediately before the ownership change. Thus, if a party that is an historic shareholder acquires additional shares for new consideration pursuant to the Signature Plan, those

additional shares would be considered 'new' shares and would not be considered historic for purposes of the 50 percent historic shareholder test. Solely for purposes of the 50 percent historic shareholder test, options or warrants of the loss corporation generally are deemed exercised if such treatment would result in the 50 percent historic shareholder test being failed. The continuity of business enterprise requirement does not apply to an ownership change that qualifies for the Section 382(1)(5) Bankruptcy Exception. The loss corporation must, however, carry on more than an insignificant amount of an active trade or business, or an acquisition may be considered to have been made for a prohibited purpose under Section 269.

(4) Alternative: Section 382(l)(6). If a loss corporation does not qualify for the Section 382(1)(5) Bankruptcy Exception or elects not to apply the Section 382(1)(5) Bankruptcy Exception, a special rule under Code Section 382(1)(6) applicable to corporations under the jurisdiction of a bankruptcy court will apply in calculating the loss corporation's value for purposes of determining the Section 382 Limitation. Under this special rule, the loss corporation's value would be the lesser of (a) the value of the loss corporation's stock immediately after the ownership change (as opposed to immediately before the ownership change, as discussed above) and (b) the value of the loss corporation's assets determined without regard to liabilities immediately before the ownership change, subject to certain adjustments specified in Section 382 and the applicable Treasury regulations. One such adjustment is a reduction in the value of a loss corporation that holds substantial nonbusiness assets immediately after an ownership change.

d) Application of Section 382 to the Debtor Group

(1) Ownership Change. To facilitate the Section 382 analysis, the Debtor has made available information regarding owner shifts in Debtor stock over the past three years. This information indicates that an approximately 34.7% owner shift has occurred over the three year period ending January 31, 2010 (an assumed Plan effective date used solely for purposes of this analysis). No assurance can be given that the information furnished by the

Debtor would be accepted by the IRS. Shares to be issued to Signature pursuant to the Signature Plan would add to this owner shift, as would certain shares acquired by Signature prior to the Petition Date. Any shares issued in respect of Section 510(b) Claims would not add to this owner shift if, as expected, such shares in the aggregate represent less than ten percent of the then outstanding shares. Based on the foregoing, it is possible that the owner shifts over the three years preceding the expected Effective Date, together with the issuance of shares to Signature pursuant to the Signature Plan, would trigger an "ownership change" of the Debtor Group. If an "ownership change" occurs, the Debtor Group's NOLs would become subject to a Section 382 Limitation unless the Section 382(1)(5) Bankruptcy Exception applies.

(2) Section 382(1)(5) Bankruptcy Exception. In order for the Section 382(1)(5) Bankruptcy Exception to apply, historic shareholders and certain creditors of the Debtor must own at least 50 percent of the Debtor's stock after the ownership change, as a result of their historic ownership. This 50 percent historic shareholder test compares stock ownership immediately before and immediately after an ownership change, and is distinct from the rolling three-year test used to determine if an ownership change has occurred. Solely for purposes of the 50 percent historic shareholder test, shares issued to Signature pursuant to the Signature Plan would be considered new shares and would not be counted as historic share ownership. Similarly, solely for purposes of the 50 percent historic shareholder test, Warrants issued pursuant to the Signature Plan would be deemed exercised, and the shares deemed issued upon exercise would be considered new shares and not historic shares. Shares issued in respect of Section 510(b) Claims likely would be considered historic shares, because these shares would be issued in respect of ordinary course claims which arose prior to the ownership change. Signature estimates that the shares issued to Signature pursuant to the plan, together with the shares that would be deemed issued upon deemed exercise of the Warrants, would be less than 50 percent of the shares outstanding after the ownership change. The remaining shares of Debtor stock, which would represent more than 50 percent of the shares

outstanding after the ownership change, would continue to be owned by historic shareholders of the Debtor. Accordingly, Signature anticipates that the 50 percent historic shareholder ownership test will be satisfied and that the Section 382(1)(5) Bankruptcy Exception will apply to the Debtor. If the Section 382(1)(5) Bankruptcy Exception applies to the Debtor, the Debtor's NOLs and built-in losses arising prior to the ownership change will not be subject to a Section 382 Limitation.

(3) Debtor's Subsidiaries. A portion of the Debtor Group's NOLs is attributable to subsidiaries of the Debtor, including FRC and FGCC. FRC and FGCC are loss corporations that are not under the jurisdiction of a court in a bankruptcy case. As noted above, the Section 382(1)(5) Bankruptcy Exception is applicable only to loss corporations that are under the jurisdiction of a court in a bankruptcy case. Pursuant to the Signature Plan, however, FRC and FGCC will be merged into the Debtor on the Effective Date. If, as expected, these mergers are treated for Federal income tax purposes as tax-free liquidations pursuant to Section 332, then the Debtor, which is under the jurisdiction of a court in a bankruptcy case, would succeed to the NOLs and certain other tax attributes of FGCC and FRC on the Effective Date. Signature intends to request the Debtor to file its tax returns for the period which includes the Effective Date in a manner which applies the Section 382(1)(5) Bankruptcy Exception not only to NOLs which were originally attributable to the Debtor, but also to NOLs to which the Debtor succeeds as a result of the mergers of FGCC and FRC into the Debtor. No assurance can be given that the Debtor will file its tax returns on this basis. Because no definitive guidance exists on the application of the Section 382(1)(5) Bankruptcy Exception to a group of corporations, and/or to the contemplated mergers/liquidations, it is unclear whether the Section 382(1)(5) Bankruptcy Exception would apply to the NOLs of FGCC and FRC.

2. Consequences to Holders of Claims.

The federal income tax consequences of the Signature Plan to a Holder of a Claim will

depend upon several factors, including but not limited to: (i) the origin and nature of the Holder's Claim, (ii) whether the Holder is a resident of the United States for tax purposes (or falls into any of the special classes of taxpayers excluded from this discussion as noted above), (iii) whether the Holder reports income on the accrual or cash basis method, (iv) whether the Holder has taken a bad debt deduction or worthless security deduction with respect to the Claim and (v) whether the Holder receives distributions under the Signature Plan in more than one taxable year. HOLDERS ARE STRONGLY ADVISED TO CONSULT THEIR TAX ADVISORS WITH RESPECT TO THE TAX TREATMENT UNDER THE SIGNATURE PLAN OF THEIR PARTICULAR CLAIMS.

a) Contingent Liability Claims

In general, the Claims can be divided into two broad categories for federal income tax purposes. The first category consists of Claims that are not treated as debt for federal income tax purposes. Most of the Administrative Claims, Priority Taxes, Priority Non-Tax Claims, General Unsecured, and Section 510(b) Claims, for example, are included in this category. The Holder of such a Claim generally should not recognize any income, gain or loss, if at all, until actual receipt of consideration under the Signature Plan (in the case of a cash basis taxpayer) or at such time as the Holder's right to consideration under the Signature Plan becomes fixed and determinable (in the case of an accrual basis taxpayer). In either case, the Holder generally should be treated no differently for federal income tax purposes than had the consideration been received with respect to the Holder's original Claim, except to the extent that a payment from the Debtor represents interest, which a Holder shall report in accordance with such Holder's method of accounting as described in the preceding sentence.

Holders of Administrative Claims, Priority Taxes, Priority Non-Tax Claims, certain General Unsecured Claims, and Section 510(b) Claims, will recognize gain or loss equal to the amount realized under the Signature Plan in respect of their Claims, less their respective tax bases in their Claims. The amount realized for this purpose will generally be equal to the amount of cash and the fair market value of common stock received under the Signature Plan

in respect of their Claims.

The character of any gain or loss recognized will depend on a number of factors, as described below. The holder's aggregate tax basis for any non-cash consideration received under the Signature Plan will generally equal the amount realized. The holding period for any non-cash consideration received under the Signature Plan will generally begin on the day following the receipt of such consideration.

b) Debt Claims

The second category of Claims consists of Claims that are treated as debt obligations for federal income tax purposes ("Debt Claims"). This category would include, among other Claims Senior Notes Claims, Junior Note Claims, and the TOPrS Claims. The payment or reinstatement of a Debt Claim under the Signature Plan will be treated as one of two possible transactions for federal income tax purposes: a continuation of the Debt Claim or payment of the Debt Claim in a fully taxable transaction.

(1) Continuation of Debt Claims.

A Holder of a TOPrS Claim or Junior Note Claim who receives (or maintains) an obligation of the Debtor under the Signature Plan that does not differ significantly from the original Claim generally should not have a taxable event for federal income tax purposes. The Holders of Allowed TOPrS Claims and Junior Note claims shall retain their legal, equitable, and contractual rights provided by the Indenture dated as of March 6, 1996, and the TOPrS and Junior Notes shall be Reinstated. Holders of such Claims generally should not have a taxable event for federal income tax purposes.

(2) Fully Taxable Transactions.

If a Debt Claim, including a Claim relating to the Senior Notes, is discharged under the Signature Plan other than through a continuation of the Debt Claim as described above, the discharge will generally constitute a fully taxable transaction to the Holder and any gain or loss realized as a result of the exchange or discharge will be recognized. A Holder whose discharge of a Debt Claim constitutes a fully taxable transaction will realize gain or loss

equal to the difference between (i) the "amount realized" in respect of the Claim and (ii) the Holder's tax basis therein. The amount realized generally will be equal to the sum of the cash received, less any amounts allocable to interest.

c) Distributions in Discharge of Accrued but Unpaid Interest.

Distributions received in respect of Allowed Claims will be allocated first to the principal amount of such Allowed Claims, with any excess allocated to accrued but unpaid interest. However, there is no assurance that the IRS will respect such allocation for federal income tax purposes. Holders of Allowed Claims not previously required to include in their taxable income any accrued but unpaid interest on an Allowed Claim may be treated as receiving taxable interest, to the extent any consideration they receive under the Signature Plan is allocable to such accrued but unpaid interest. Holders previously required to include in their taxable income any accrued but unpaid interest on an Allowed Claim may be entitled to recognize a deductible loss, to the extent that such accrued but unpaid interest is not satisfied under the Signature Plan. Holders should consult their own tax advisors concerning the allocation of consideration received in satisfaction of their Allowed Claims and the federal income tax treatment of accrued but unpaid interest.

d) Character of Gain or Loss.

The character of any gain or loss as long-term or short-term capital gain or loss or as ordinary income or loss recognized by a holder of Allowed Claims under the Signature Plan will be determined by a number of factors, including, but not limited to, the status of the holder, the nature of the Allowed Claim in such holder's hands, the purpose and circumstances of its acquisition, the holder's holding period of the Allowed Claim, and the extent to which the holder previously claimed a loss, bad debt deduction or charge to a reserve for bad debts with respect to the Allowed Claim. In this regard, section 582(c) of the IRC provides that the sale or exchange of a bond, debenture, note or certificate, or other evidence of indebtedness by a bank or certain other financial institutions, will not be considered the sale or exchange of a capital asset. Accordingly, any gain recognized by such creditors as a result of the

implementation of the Signature Plan will be ordinary income.

In general, if a creditor holds a Debt Claim as a capital asset, any gain recognized will be classified as capital gain, except to the extent of interest (including accrued market discount, if any, as described below), and any loss required to be recognized will be classified as capital loss. Such gain or loss will be long-term with respect to Debt Claims for which the creditor's holding period is more than one year. There is a favorable tax rate applied to long-term capital gains for non-corporate holders. Any capital losses realized generally may be used by a corporate holder only to offset capital gains, and by an individual holder only to the extent of capital gains plus $3,000 of other income.

e) Market Discount.

Generally, a "market discount" bond is one acquired after its original issuance for less than the issue price of such bond plus the aggregate amount, if any, of original issue discount includible in the income of all holders of such bond before such acquisition. Generally, gain realized on the disposition of a market discount bond (or on the disposition of property exchanged for such bond in certain non-taxable exchanges) will be ordinary income to the extent of "accrued market discount" at the time of such disposition (determined using either constant interest or ratable daily accrual).

3. Consequences to Holders of Equity Interests.

Pursuant to the Signature Plan, all Equity Interests are being reinstated. A holder of an Equity Interest should not have a taxable event for federal income tax purposes.

4. Withholding.

All Distributions to holders of Allowed Claims under the Signature Plan are subject to any applicable withholding, including employment tax withholding. The Debtor and/or the Post-Confirmation Estate will withhold appropriate employment taxes with respect to payments made to a holder of an Allowed Claim which constitutes a payment for compensation. Payors of interest, dividends, and certain other reportable payments are generally required to withhold from such payments if the payee fails to furnish such payee's

correct taxpayer identification number (social security number or employer identification number), to the payor. This rate is currently 30% but is scheduled to be reduced in future years. The Debtor and/or the Post-Confirmation Estate may be required to withhold a portion of any payments made to a holder of an Allowed Claim if the holder (i) fails to furnish the correct social security number or other taxpayer identification number ("TIN") of such holder, (ii) furnishes an incorrect TIN, (iii) has failed to properly report interest or dividends to the IRS in the past or (iv) under certain circumstances, fails to provide a certified statement signed under penalty of perjury, that the TIN provided is the correct number and that such holder is not subject to backup withholding. Backup withholding is not an additional tax but merely an advance payment, which may be refunded to the extent it results in an overpayment of tax. Certain persons are exempt from backup withholding, including, in certain circumstances, corporations and financial institutions.

AS INDICATED ABOVE, THE FOREGOING IS INTENDED TO BE A SUMMARY ONLY AND NOT A SUBSTITUTE FOR CAREFUL TAX PLANNING WITH A TAX PROFESSIONAL. THE FEDERAL, STATE, LOCAL AND OTHER TAX CONSEQUENCES OF THE SIGNATURE PLAN ARE COMPLEX AND, IN SOME CASES, UNCERTAIN. ACCORDINGLY, EACH HOLDER OF A CLAIM OR INTEREST IS URGED TO CONSULT SUCH HOLDER'S TAX ADVISORS CONCERNING THE FEDERAL, STATE, LOCAL AND OTHER TAX CONSEQUENCES APPLICABLE UNDER THE SIGNATURE PLAN.

H. Transfer Restrictions: the "Leucadia Provision"

The Signature Plan requires that the Reorganized Debtor and its affiliates amend and restate certain of their corporate governance documents (such as certificate of incorporation, bylaws, or similar charter documents) to the extent necessary to, among other things: 1) authorize the restructuring transactions contemplated by the Signature Plan, including but not limited to the issuance of preferred stock and warrants to be issued under the Signature Plan and the authorization of common stock underlying those securities, and 2) at the option of

Signature, impose a "Leucadia Provision" to restrict certain transfers of the common stock or other equity of the Reorganized Debtor in order to avoid adverse federal income tax consequences caused by certain subsequent ownership changes (as defined in section 382 of the Internal Revenue Code of 1986, as amended (the "Tax Code")), as described in more detail below.

Signature believes that the Leucadia Provision will enhance shareholder value by helping preserve the NOLs to offset future taxable income., and that the equity holders of the Reorganized Debtor would be in good and wise company to adopt a Plan that includes a 5% Leucadia Provision. For example, Berkadia LLC, a joint venture between Berkshire Hathaway, Inc. and Leucadia National Corporation, proposed a similar 5% restriction in its plan which helped the FINOVA Group, Inc. emerge from bankruptcy. Many other companies, including those emerging from bankruptcy, have adopted similar 5% trading restrictions. These companies include Lear Corporation (NYSE: LEA), Pulte Home, Inc. (NYSE: PHM), Deerfield Capital Corp. (NYSE Alternext: DFR), Quixote Corporation (Nasdaq: QUIX) and Meritage Homes Corporation (NYSE:MTH), to name a few.

Signature's plan includes a 5% Leucadia Provision to restrict transfers on certain shares of the common stock with the following material terms, and subject to the following exceptions:

- no Person (other than Signature and its affiliates may acquire or accumulate five percent or more (as determined under tax law principles governing the application of Section 382 of the Tax Code) of the common stock or other equity of the Reorganized Debtor (together, "the Securities"); and
- no Person (other than the Signature and its affiliates) owning directly or indirectly (as determined under such tax law principles) on the Effective Date, after giving effect to the Signature Plan, or after any subsequent issuances of securities pursuant to transactions contemplated by the Signature Plan, five percent or more (as determined under such tax law principles) of the Securities, may acquire

additional shares of that common stock or other equity of the Reorganized Debtor, subject to certain exceptions, and

- no person (other than Signature and its affiliates) holding 5% or more of the total fair market value of the Securities may transfer, or agree to transfer, Securities.

The restrictions on transfer will not apply to:

- certain transactions approved by the board of directors of the Reorganized Debtor;
- an acquisition by Signature of Securities which, as a percentage of the total shares outstanding, is not greater than the difference between 49% and the percentage of the total shares outstanding acquired by Signature or any of its subsidiaries in the Signature Plan plus any additional Securities acquired by Signature and its affiliates;
- a transfer of Securities by Signature on or prior to the second anniversary of Effective Date which, together with any transfers of Securities by Signature since the Effective Date, represent less than 15% of the issued and outstanding Securities at the time of the transfer;
- a transfer or acquisition of Securities by Signature after the second anniversary of the Effective Date that would otherwise be disallowed under the transfer restriction, so long as such transaction and any other similar transactions consummated by Signature during the three years prior to the consummation of such transaction (and after the Effective Date), as a whole constitute less than 15% of the issued and outstanding Securities at the time of the transaction; and
- a transfer or acquisition of Securities by any holder of Securities other than Signature that would otherwise be disallowed under the transfer restriction, so long as such transaction and any other similar transactions consummated by holders of Securities (other than Signature) during the three years prior to the consummation of such transaction (and after the Effective Date), as a whole

constitute less than 15% of the issued and outstanding Securities at the time of the transaction.

In addition, the restrictions on transfer will not apply to Mr. McIntyre, who served as the Debtor's CEO from its pubic offering in 1970 until retirement in 2004 and as of the Petition Date beneficially owned (as that term is defined in the rules of the SEC) in excess of 10% of the Debtor's issued and outstanding Common Stock.

The purpose of the Leucadia Provision is to reduce the risk that any change in the ownership of the Reorganized Debtor's common stock may jeopardize the preservation of federal income tax attributes of the Reorganized Debtor for purposes of section 382 and 383 of the Tax Code. In particular, Signature believes the transfer restriction is an important measure to protect the value of the NOLs carried by the Reorganized Debtor. In addition, Signature believes that transfer restrictions will help stabilize the capitalization of the Reorganized Debtor.

In conjunction with the 5% trading restriction described above, in order to further reduce the risk that a change in ownership of the Reorganized Debtor's common stock will occur that may jeopardize favorable federal income tax attributes, each certificate representing shares of the Reorganized Debtor's common stock shall bear a legend in substantially the following form:

"The shares of Reorganized Debtor's common stock represented by this certificate are issued pursuant to the Signature Plan of Reorganization for the Reorganized Debtor, as confirmed by the United States Bankruptcy Court for the Central District of California. The transfer of securities represented hereby is subject to restriction pursuant to Article [__] of the Certificate of Incorporation of the Reorganized Debtor. The Reorganized Debtor will furnish a copy of its Certificate of Incorporation to the holder of record of this certificate without charge upon written request addressed to the Reorganized Debtor at its principal

place of business."

I. Retention of Jurisdiction

The Bankruptcy Court will retain jurisdiction of all matters arising in or related to the Signature Plan to the fullest extent provided by law until the Signature Plan is fully consummated, including, without limitation:

a. The adjudication of the validity, scope, classification, allowance, and disallowance of any Claim;

b. The estimation of any Claim;

c. The allowance or disallowance of Professional Fee Claims, compensation, or other Administrative Claims;

d. To hear and determine Claims concerning taxes pursuant to sections 346, 505, 525, and 1146 of the Bankruptcy Code;

e. To hear and determine any action or proceeding brought under sections 108, 510, 543, 544, 545, 547, 548, 549, 550, 551, and 553 of the Bankruptcy Code;

f. To hear and determine all actions and proceedings relating to pre-confirmation matters;

g. To hear and determine any issue relating to the assumption or rejection of executory contracts and unexpired leases;

h. To hear and determine any modification to the Signature Plan in accordance with the Bankruptcy Rules and the Bankruptcy Code;

i. To enforce and interpret terms of the Signature Plan;

j. To correct any defects, cure any omissions, or reconcile any inconsistency in the Signature Plan r the Confirmation Order as may be necessary to carry out the purpose and intent of the Signature Plan;

k. To hear and determine such matters and make such orders as are consistent with the Signature Plan as may be necessary to carry out the provisions thereof and to adjudicate any disputes arising under or related to any order entered by the Court in this Case; and

l. The entry of an order concluding and terminating this Case.

J. Claims

1. **Maintenance of Post-Confirmation Claims Register**

In order to reduce the administrative burdens on the Bankruptcy Court and to improve

UNITED STATES BANKRUPTCY COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

In re:	:	Chapter 11
RESIDENTIAL CAPITAL, LLC, *et. al.*	:	Case Number 12-12020 (MG) (Jointly Administered)
Debtors.	:	

REPORT OF ARTHUR J. GONZALEZ, AS EXAMINER

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CHADBOURNE & PARKE LLP
30 Rockefeller Plaza
New York, New York 10112
Telephone: (212) 408-5100
Facsimile: (212) 541-5369

Howard Seife
David M. LeMay
Thomas J. McCormack
N. Theodore Zink, Jr.
Robin D. Ball
Seven R. Rivera
Andrew Rosenblatt
Marc D. Ashley
Christy L. Rivera
Francisco Vazquez

Counsel to Examiner

MESIROW FINANCIAL CONSULTING, LLC
666 Third Avenue, 21st Floor
New York, New York 10017
Telephone: (212) 808-8330
Facsimile: (212) 682-4995

Ralph S. Tuliano
James C. Atkinson
James F. Feltman
Melissa Kibler Knoll
Jack F. Williams

Financial Advisors to Examiner

indemnify Ally Bank for losses incurred as a result of certain loan modifications undertaken in connection with the government settlements. The Examiner concludes it is likely that an action on behalf of GMAC Mortgage against Ally Bank to avoid and recover the May 10 and 11, 2012 payments as preferential transfers under Bankruptcy Code sections 547 and 550 would prevail.

In addition, the Examiner considered whether the postpetition payment of $12.9 million to Ally Bank relating to prepetition indemnification obligations under the terms of the A&R Servicing Agreement would be avoidable under Bankruptcy Code section 549. The Examiner concludes that the payment was not made in the ordinary course of the Debtors' business, and therefore could only be made if authorized by the Bankruptcy Court. While it is a close question, based on the Debtors' express representations in the related motion and the lack of complete disclosure, it appears more likely than not that the interim order authorizing continued performance under the A&R Servicing Agreement did not authorize the Debtors to make payments to satisfy prepetition obligations. Accordingly, the Examiner concludes that, while a close question, it is more likely than not that an action to avoid and recover the $12.9 million payment under Bankruptcy Code sections 549(a) and 550 would prevail.

3. Causes Of Action Relating To Use And Allocation Of ResCap's Tax Attributes

The Examiner reviewed the historical and prospective use and allocation, as between ResCap and AFI, of ResCap's tax attributes.[12] A primary focus of the Examiner's tax-related analysis was on ResCap's entry into a tax allocation agreement that was effective beginning in the 2009 tax year.[13] A first version of the tax allocation agreement (the First 2009 Tax Allocation Agreement) was drafted to treat ResCap as if it were a stand-alone taxpayer, with an additional proviso that was very favorable to ResCap—AFI would pay ResCap for ResCap's tax benefits that AFI could use even if ResCap could not yet use the tax benefits on a stand-alone basis.

The First 2009 Tax Allocation Agreement was signed by AFI and unanimously approved by the ResCap Board on August 6, 2010. But it was never signed by James Young, ResCap's officer who was meant to sign the agreement on behalf of ResCap. Sometime in October 2010, AFI asked Young not to sign the agreement. AFI had a change of heart after it calculated what it would owe ResCap under the agreement and realized it would owe ResCap hundreds of millions of dollars.

AFI then proposed a second version of the tax allocation agreement (the Second 2009 Tax Allocation Agreement) that not only removed ResCap's right to receive payments from AFI for AFI's use of ResCap's tax benefits, but resulted in ResCap having to pay AFI for tax on excess inclusion income, which from 2009 through 2012 totaled approximately $50 million. This Second 2009 Tax Allocation Agreement, portions of which counsel for the Independent Directors had described as being "very unfair" to ResCap, was nevertheless approved by the ResCap Board and signed by all parties. The Second 2009 Tax Allocation Agreement is still putatively in effect today.

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[12] For the Examiner's full analysis of tax sharing and allocation issues, see Sections V.D and VII.K.

[13] The Examiner also reviewed the Implemented 2005 Tax Allocation Agreement and concludes it is likely that ResCap would prevail on a contractual claim to receive compensation of up to $15.1 million.

Among other issues, the Examiner considered whether the First 2009 Tax Allocation Agreement is a valid and enforceable contract, despite not having been signed by a ResCap officer. Under Michigan contract law (the law governing both 2009 Tax Allocation Agreements), approval by the ResCap Board, after AFI and ResCap officers completed extensive negotiations over the terms of the agreement, constituted ResCap's consent to the contract. The Examiner concludes that, while a close question, it is more likely than not that the First 2009 Tax Allocation Agreement that was approved by the ResCap Board and signed by AFI was a valid and enforceable contract.

The Examiner also considered whether the Second 2009 Tax Allocation Agreement could be set aside as a fraudulent transfer. ResCap was insolvent when it entered into the Second 2009 Tax Allocation Agreement and did not receive reasonably equivalent value from AFI for entering into the agreement. Accordingly, the Examiner concludes it is likely that the Second 2009 Tax Allocation Agreement, which purports to supersede the First 2009 Tax Allocation Agreement, can be avoided as a constructive fraudulent transfer.

Based on the Examiner's conclusions, upon the avoidance of the Second 2009 Tax Allocation Agreement, ResCap would have a contractual claim against AFI under the First 2009 Tax Allocation Agreement based on AFI's use of ResCap's tax benefits that have passed since the 2009 tax year. Based on the anticipated use by AFI of ResCap's tax benefits, ResCap's contract claim against AFI is estimated to be $1.77 billion.

4. Minnesota Insider Preference Claims

After performing a choice of law analysis, the Examiner concludes that Minnesota's substantive fraudulent transfer law is likely to govern claims brought by the respective Estates of ResCap and RFC under Bankruptcy Code section 544(b). Minnesota's adoption of the Uniform Fraudulent Transfer Act contains an "Insider Preference" Cause of Action.[14] A transfer is fraudulent under the Insider Preference statute if: (1) there exists a creditor of the transferor-debtor whose claim arose before the transfer; (2) the transfer was made to an insider of the debtor; (3) the transfer was made for an antecedent debt; (4) the debtor was insolvent at the time of the transfer; and (5) the insider had reasonable cause to believe the debtor was insolvent. The premise of this Cause of Action "is that an insolvent debtor is obliged to pay debts to creditors not related to him before paying those who are insiders."[15]

Although this Cause of Action resembles the preference-avoidance provisions of Bankruptcy Code section 547, it does not contain a "hypothetical chapter 7" test to determine which transfers could be avoided. Accordingly, the Examiner concludes that—with certain limitations—the Insider Preference statute likely could be used to avoid payments made to a

[14] *See* Minn. Stat. Ann. § 513.45(b). For the Examiner's full analysis of the Minnesota Insider Preference statute, see Section VII.F.4. For the Examiner's full analysis of potential actual and constructive fraudulent transfer claims that might be asserted on behalf of the Debtors' Estates pursuant to Bankruptcy Code sections 544(b) and 548, see Section VII.F.6.

[15] UFTA, Prefatory Note, at 4.

The 2006 ResCap LLC Agreement and the 2008 ResCap Amended LLC Agreement both provide for indemnification and exculpation of directors for acts or omissions in good faith on behalf of ResCap that were reasonably believed to be within the scope of the director's authority. This indemnification and exculpation is subject to certain exclusions, such as for acts or omissions as a result of the director's willful misconduct or bad faith. AFI's certificate of incorporation generally provides for indemnification of directors serving on the boards of other entities at the request of AFI, if the directors acted in good faith and in a manner reasonably believed to be aligned with the best interests of AFI.

c. Breach Of Fiduciary Duty Claims Against ResCap's Directors And Officers

As ResCap faced increasingly challenging circumstances over time, ResCap fiduciaries often operated under stressful conditions and within a tangled relationship with AFI. Despite the volume and intensity of the ResCap Board's activities, the protocol, processes, and functioning of the ResCap Board were far from optimal.

Yet there exist only a few potentially actionable claims for breaches of fiduciary duties against ResCap's directors and officers.[28] A threshold hurdle for any such claims is that, prior to August 15, 2007—the date at which the Examiner concludes that ResCap was left with unreasonably small capital and reasonably should have believed that it would incur debts beyond its ability to pay—ResCap fiduciaries owed duties to ResCap's parent shareholder and not to its creditors. The Examiner concludes that no potential claims for breach of fiduciary duty are likely, or more likely than not, to prevail, although troubling facts in connection with fiduciary conduct do exist.

The facts surrounding the ResCap Board's approval of the 2006 Bank Restructuring give rise to potential fiduciary duty claims that, although unlikely to prevail because of legal impediments, are close questions. The evidence indicates that certain material information, relating to ResCap's potential negotiating leverage with respect to obtaining a voting interest in the restructured bank, was purposefully withheld from ResCap's Independent Directors by inside managers in an effort to secure approval of the transaction on the proposed terms. The Independent Directors' approval of the 2006 Bank Restructuring, therefore, was arguably procured on false premises. However, several formidable legal obstacles exist to any related claim for breach of fiduciary duty, including the absence of a definitive fiduciary duty to disclose the withheld information, as well as a possible timeliness deficiency.

Similarly, the facts underlying approval of the Second 2009 Tax Allocation Agreement by the ResCap Board are troubling because the agreement imposed an obligation on ResCap to make certain payments to AFI that ResCap was not otherwise obligated to make as a disregarded entity, and did not contain any provisions providing for the possibility of any payments being made by AFI to ResCap for AFI's use of ResCap's tax benefits.[29] Despite the

[28] For the Examiner's full analysis of potential Causes of Action against ResCap's current or former directors and officers, see Section VII.E and VII.K. Potential fiduciary duty claims relating to transactions that the Examiner determined were not problematic are not addressed.

[29] For the Examiner's full analysis of tax sharing and allocation issues, see Sections V.D and VII.K.

unfair nature of the Second 2009 Tax Allocation Agreement, the evidence established that the agreement went through a thorough review process by the ResCap Board, including review and comment by the Independent Directors and their counsel. These and other relevant facts lead the Examiner to conclude that, while a close question, it is more likely than not that a breach of fiduciary duty claim based on the ResCap Board's approval of the Second 2009 Tax Allocation Agreement would not prevail.

The Examiner also analyzed whether Young violated a fiduciary duty for failing to sign the First 2009 Tax Allocation Agreement after it was approved by the ResCap Board and signed by AFI. Although the Examiner found evidence suggesting that Young did not advocate strongly for ResCap's interests in seeking to enforce or preserve the First 2009 Tax Allocation Agreement, the evidence does not establish that Young intentionally failed to advance ResCap's interests or failed to act in a way that would demonstrate a conscious disregard for his duties. Accordingly, the Examiner concludes that, while a close question, it is more likely than not that a claim for breach of fiduciary duty against Young would not prevail.

The Examiner concludes it is unlikely that potential claims for breach of fiduciary duty related to the Prepetition Asset Sales would prevail. In addition, while a close question, the Examiner concludes it is more likely than not that potential breach of fiduciary duty claims would not prevail with respect to the $48.4 million payment under the January 30 Letter Agreement and A&R Servicing Agreement in May 2012. Those various Affiliate Transactions were generally the product of extensive, arm's-length negotiations and informed decision making by ResCap fiduciaries, even if carried out in harried circumstances.

Finally, while the efforts of the ResCap Board in connection with approval of the AFI Settlement and Plan Sponsor Agreement and the RMBS Trust Settlement Agreements were flawed, the Examiner concludes that no viable claims exist for breaches of fiduciary duties tied to those Board approval processes. The performance of the Independent Directors who comprised the Special Review Committee responsible for the claims investigation that led to the now-terminated AFI Settlement and Plan Sponsor Agreement was incomplete, tainted by certain counsel conflicts, and otherwise flawed, thus creating a close question. But it is more likely than not that a related claim for breach of fiduciary duty would not prevail. Based on the investigation performed by its legal counsel, the ResCap Board concluded that the proposed settlement with AFI was a reasonable resolution of challenging litigation claims. Similarly, the process that led to approval by the ResCap Board of the RMBS Trust Settlement Agreements within a condensed timeframe was not optimal. However, the Examiner also concludes that, while a close question, it is more likely than not that a claim for breach of fiduciary duty against the ResCap Board related to its approval of the RMBS Trust Settlement Agreements would not prevail. The ResCap Board acted on a sufficiently informed basis and with a good-faith belief that the settlement of major claims embodied in the agreements would facilitate the interests of ResCap and its creditors.

d. Aiding And Abetting Breach Of Fiduciary Duty Claims Against AFI

As noted above, the Examiner concludes that, although ResCap fiduciaries engaged in certain problematic conduct in connection with particular transactions, no related fiduciary

THIS IS NOT A SOLICITATION OF ACCEPTANCE OR REJECTION OF THE SEVENTH AMENDED PLAN. ACCEPTANCES OR REJECTIONS MAY NOT BE SOLICITED UNTIL A DISCLOSURE STATEMENT HAS BEEN APPROVED BY THE BANKRUPTCY COURT. THIS DISCLOSURE STATEMENT IS BEING SUBMITTED FOR APPROVAL BUT HAS NOT YET BEEN APPROVED BY THE BANKRUPTCY COURT.

UNITED STATES BANKRUPTCY COURT
DISTRICT OF DELAWARE

In re	:	**Chapter 11**
WASHINGTON MUTUAL, INC., et al.,[1]	:	**Case No. 08-12229 (MFW)**
Debtors.	:	**(Jointly Administered)**

DISCLOSURE STATEMENT FOR THE SEVENTH AMENDED JOINT PLAN OF AFFILIATED DEBTORS PURSUANT TO CHAPTER 11 OF THE UNITED STATES BANKRUPTCY CODE

WEIL, GOTSHAL & MANGES LLP
767 Fifth Avenue
New York, New York 10153
(212) 310-8000

-and-

RICHARDS, LAYTON & FINGER, P.A.
One Rodney Square
920 North King Street
Wilmington, Delaware 19801
(302) 651-7700

Attorneys for Debtors
and Debtors in Possession

Dated: December 12, 2011

[1] The Debtors in these chapter 11 cases along with the last four digits of each Debtor's federal tax identification number are: (i) Washington Mutual, Inc. (3725); and (ii) WMI Investment Corp. (5395). The Debtors' principal offices are located at 925 Fourth Avenue, Suite 2500, Seattle, Washington 98104.

needs include expenses related to officers/management, supplies, rent/infrastructure, director fees, and D&O/Liability insurance.

Interest Expense: Interest expense relates to the 13% interest rate per annum that will be paid in-kind, or in Cash if available, on the outstanding portion of the Runoff Notes (initially $130,000,000.00). In addition, the Debtors assume no draws on the Credit Facility during the Projection Period and as a result there is no interest expense associated with that facility.

Investment Income: WMMRC's assets contained in six MI trusts and one custodial account are invested in various high-grade products, including money markets (12% of total cash and investments), treasuries (0%), agencies (29%), corporate bonds (44%), mortgage securities (7%), and foreign issues (8%). Current yields on the mix above provide a return of 3.0%. The Debtors assumed a fixed yield of 3.5% over the Projections period—though the yields could be materially different given future decisions on investment mix. WMMRC is precluded from investing trust assets in lower grade investments per the reinsurance agreements.

Tax Expense: No provision for federal tax expense has been made during the Projection Period as the Projections do not anticipate the Reorganized Debtors generating any pre-tax income. In addition, if the Reorganized Debtors were to generate pre-tax income, it is assumed that the entities would be able to take advantage of retained WMI tax attributes providing for NOL carryforwards sufficient to cover projected earnings streams. For a discussion of potential limitations and other considerations with respect to the availability of sufficient NOL carryforwards see Article VIII hereof.

Public Reporting Expenses: Public reporting expenses were projected based on the requirements of Reorganized WMI to file audited financial reports with the SEC and send Reorganized WMI's shareholders financial and voting materials. Projections include upfront expenses and on-going expenses, which were assumed to grow at a 3% annual inflation rate over the projection period.

VIII.
CERTAIN FEDERAL INCOME TAX CONSEQUENCES OF THE SEVENTH AMENDED PLAN

The following discussion summarizes certain U.S. federal income tax consequences of the implementation of the Seventh Amended Plan to the Debtors and to holders of Claims and Equity Interests. The following summary generally does not address the U.S. federal income tax consequences to holders whose Claims are unimpaired or otherwise entitled to payment in full in cash under the Seventh Amended Plan (*e.g.*, Allowed Administrative Expense Claims, Allowed Professional Compensation and Reimbursement Claims, Allowed Priority Non-Tax Claims, and Allowed WMI Vendor Claims) or whose distributions are governed by the Global Settlement Agreement, or to holders of Claims that are deemed to reject the Seventh Amended Plan (*e.g.*, WMB Subordinated Notes Claims).

The following summary is based on the Internal Revenue Code (the "IRC"), U.S. Treasury regulations promulgated thereunder, judicial decisions, and published administrative rules and pronouncements of the IRS, all as in effect on the date hereof. Changes in such rules or new interpretations thereof may have retroactive effect and could significantly affect the U.S. federal income tax consequences described below.

The U.S. federal income tax consequences of the Seventh Amended Plan are complex and are subject to significant uncertainties. The Debtors have not requested an opinion of counsel with respect to any of the tax aspects of the Seventh Amended Plan. The Debtors have obtained rulings from the IRS as to certain tax aspects of the Seventh Amended Plan as indicated herein, and do not currently

anticipate seeking any additional rulings from the IRS with respect to the remaining tax aspects of the Seventh Amended Plan. In addition, this summary generally does not address foreign, state or local tax consequences of the Seventh Amended Plan, nor does it address the U.S. federal income tax consequences of the Seventh Amended Plan to special classes of taxpayers (such as foreign taxpayers, broker-dealers, traders that mark-to-market their securities, banks, mutual funds, insurance companies, other financial institutions, small business investment companies, regulated investment companies, real estate investment trusts, tax-exempt organizations, retirement plans, persons whose functional currency is not the U.S. dollar, persons subject to the alternative minimum tax, persons holding Claims or Equity Interests as part of a "straddle," "hedge," "constructive sale" or "conversion transaction" with other investments, pass-through entities and investors in pass-through entities). If a partnership (including any entity treated as a partnership for tax purposes) holds Claims or Equity Interests, the tax treatment of a partner (or member) will generally depend upon the status of the partner (or member) and upon the activities of the partnership. Moreover, the following discussion generally does not address U.S. federal taxes other than income taxes, nor does it apply to any person that acquires any of the exchange consideration in the secondary market.

This discussion assumes, except where otherwise indicated, that the Claims, Equity Interests, Runoff Notes, and Reorganized Common Stock are held as "capital assets" (generally, property held for investment) within the meaning of section 1221 of the IRC.

In connection with the Seventh Amended Plan, the AAOC has committed to enter into the Credit Facility for purposes of financing Reorganized WMI. However, certain qualifying Claim and Equity Interest holders may choose to become a lender under the Credit Facility. The following discussion assumes that the right of such holders to become lenders does not constitute additional consideration in respect of their Claims or Equity Interests. Any holder considering participating in the Credit Facility should consult its tax advisor regarding the federal income tax consequences of becoming, and being, a lender under the Credit Facility. Such consequences are not discussed herein.

The following summary of certain U.S. federal income tax consequences is for informational purposes only and is not a substitute for careful tax planning and advice based upon the individual circumstances pertaining to a holder of a Claim or Equity Interest.

***IRS Circular 230 Notice**. To ensure compliance with IRS Circular 230, holders of Claims and Equity Interests are hereby notified that: (a) any discussion of federal tax issues contained or referred to in this Disclosure Statement is not intended or written to be used, and cannot be used, by holders of Claims and Equity Interests for the purpose of avoiding penalties that may be imposed on them under the IRC; (b) such discussion is written in connection with the promotion or marketing by the Debtors of the transactions or matters addressed herein; and (c) holders of Claims and Equity Interests should seek advice based on their particular circumstances from an independent tax advisor.*

A. Consequences to the Debtors

For U.S. federal income tax purposes, the Debtors are members of an affiliated group of corporations which files a consolidated U.S. federal income tax return, of which WMI is the common parent (previously defined as the "Tax Group").

The Tax Group reported a substantial consolidated NOL and certain credit carryforwards for federal income tax purposes for the taxable year of the Tax Group ended December 31, 2008, which have been reduced by income generated (on a collective basis) in the two subsequent taxable years. In accordance with U.S. federal income tax law, NOLs are generally first carried back (to the extent permitted) to offset prior years' income, before being available to be carried forward. Thus, a portion of

the NOLs incurred by the Tax Group for its taxable year ended December 31, 2008 was carried back to reduce certain asserted tax adjustments and the Tax Group's reported taxable income in prior years, generating the majority of the substantial Tax Refunds that will be allocated pursuant to the Global Settlement Agreement, as discussed in Section V.B.3.b(ii) above. The remaining portion of such NOLs, after reduction by the net income generated in subsequent years, is approximately $17.7 billion as of December 31, 2010 and currently is available to the Tax Group as an NOL carryforward that can offset future income. The Debtors may have a small amount of additional NOL in the taxable year ending December 31, 2011. Substantially all of such NOL carryforwards, however, are attributable to the operations of WMB and its former subsidiaries or to the FDIC Receiver's sale of substantially all of WMB's assets to JPMC, and thus will cease to be available to the Reorganized Debtors as of the date WMB ceases to be a member of the Tax Group—such as when the FDIC distributes all of the WMB receivership assets to WMB's creditors, or in the event that WMI abandons its stock interest in WMB. Moreover, if an ownership change were to occur on the Effective Date, the continued availability of the estimated $17.7 billion NOL thereafter would be subject in its entirety to the annual limitation imposed by section 382 of the IRC (discussed in more detail in Section VIII.A.2.a below). The annual limitation would, at most, only be approximately $6 million per year, and it is possible that no portion of such NOL would be available to offset income of the Tax Group after the Effective Date.

Because Reorganized WMI's use of the estimated $17.7 billion NOL attributable to WMB, if available at all, would be so severely restricted in the event of an ownership change, the Debtors do not intend to attempt to preserve that NOL and, rather, WMI currently expects to take advantage of a portion of the NOL that will result if WMI abandons its equity investment in WMB prior to the Effective Date. If WMI abandons its equity investment in WMB *prior* to the Effective Date, a substantial NOL may still be available to Reorganized WMI even if a change in ownership occurs on the Effective Date of the Seventh Amended Plan. Specifically, WMI has a substantial tax basis in its stock investment in WMB. Although the Debtors believe that such stock investment is currently worthless, WMI is precluded from claiming a worthless stock deduction with respect to all or part of such stock prior to WMB ceasing to be a member of the Tax Group (such as by reason of the distribution by the FDIC of all the WMB receivership assets to WMB creditors or the abandonment by WMI of its stock investment), at which point the estimated consolidated $17.7 billion NOL attributable to WMB would no longer be available to the Tax Group. Nonetheless, the worthless stock deduction (the "Stock Loss") from a pre-Effective Date abandonment (which, based on a ruling obtained by the Debtors from the IRS, would be ordinary in character), together with deductions incurred in connection with the implementation of the plan (such as distributions in respect of postpetition interest and in release of the WMB Senior Notes Claims), would result in a substantial NOL for the taxable year in which the Effective Date occurs in an estimated amount of approximately $7.4 billion.[3] The availability of such NOL, however, would be subject to, among other things, (i) reduction under the tax rules applicable to the cancellation of debt, and (ii) any applicable limitations imposed by the ownership change rules of the IRC, discussed below. Regardless of when the Effective Date occurs or whether WMI abandons its equity investment in WMB, the current projected income of Reorganized WMI as reflected in the Projections (*see* Article VII) only utilizes a small portion of the estimated available NOL. Any additional usage of the NOL (if otherwise available) primarily

[3] This takes into account a Stock Loss of approximately $5.5 billion, based on WMI's current estimate of its adjusted tax basis in the stock of WMB. WMI's adjusted tax basis, and thus the resulting Stock Loss and NOL prior to the potential application of section 382 of the IRC, may potentially increase by approximately $3.6 billion in the event certain amounts provided for under the Global Settlement Agreement are respected for federal income tax purposes as capital contributions. The parties to the Global Settlement Agreement have generally agreed to treat all amounts paid, waived, allocated or transferred by WMI to WMB, the FDIC Receiver, FDIC Corporate or to JPMC as capital contributions from WMI to WMB, which amounts may be significant. Whether and the extent to which such amounts will be respected as capital contributions for federal income tax purposes, increasing stock basis and the Stock Loss, however, is uncertain.

depends on the extent to which Reorganized WMI acquires additional assets that generate additional income.

1. Cancellation of Debt

In general, the IRC provides that a debtor in a bankruptcy case must reduce certain of its tax attributes—including NOL carryforwards and current year NOLs, capital loss carryforwards, tax credits, and tax basis in assets (but not below the amount of liabilities to which the debtor remains subject)—by the amount of any cancellation of debt ("COD") incurred pursuant to a confirmed chapter 11 plan. The amount of COD incurred for federal income tax purpose is generally the amount by which the indebtedness discharged exceeds the value of any consideration given in exchange therefor. Certain statutory or judicial exceptions may apply to limit the amount of COD incurred. If advantageous, the borrower can elect to reduce the basis of depreciable property prior to any reduction in its NOL carryforwards or other tax attributes. Where the borrower joins in the filing of a consolidated U.S. federal income tax return, applicable Treasury regulations require, in certain circumstances, that the tax attributes of the consolidated subsidiaries of the borrower and other members of the group also be reduced. Any reduction in tax attributes in respect of COD incurred does not occur until the end of the taxable year after such attributes have been applied. As a result, any income incurred on the Effective Date in connection with the implementation of the Seventh Amended Plan, or prior to the end of such taxable year, generally could be offset by any NOL carryforwards or current year NOLs of the Tax Group prior to any attribute reduction on account of any COD incurred, *but subject to* the ownership change rules of the IRC, discussed below.

Based on the estimated recovery percentages (taking into account the Global Settlement Agreement) and the projected amount of Allowed Claims, the Debtors expect to incur approximately $850 million of COD as a result of the implementation of the Seventh Amended Plan (taking into account subordination provisions and based on the Bankruptcy Court's determination of value, *see* Section I.C above). The Debtors expect to wholly or partially offset such COD income with post-petition interest deductions to which the Debtors would be entitled upon implementation of the Seventh Amended Plan, which deductions are included in the $7.4 billion estimated NOL for the taxable year in which the Effective Date occurs.

2. Potential Limitations on NOL Carryforwards and Other Tax Attributes

Upon the implementation of the Seventh Amended Plan, any remaining NOL carryforwards and certain other tax attributes allocable to periods prior to the Effective Date will be subject to limitation following the Effective Date, assuming a resulting change in the ownership of the Tax Group. These limitations apply in addition to the attribute reduction that may result from any COD incurred in connection with the discharge of Claims pursuant to the Seventh Amended Plan.

a. Section 382.

Under section 382 of the IRC, if a corporation (or consolidated group) undergoes an "ownership change," the amount of its pre-change losses (including certain losses or deductions which are "built-in," *i.e.*, economically accrued but unrecognized, as of the date of the ownership change) that may be utilized to offset future income generally are subject to an annual limitation. It is unclear whether the implementation of the Seventh Amended Plan would result in an ownership change of the Debtors. Such determination depends, in part, on the extent to which creditors choose to receive Reorganized Common Stock under the Seventh Amended Plan and the status of certain of the Preferred Equity Interests as "stock" for purposes of Section 382. The remainder of this disclosure conservatively assumes that the issuance of Reorganized Common Stock pursuant to the Seventh Amended Plan will constitute an

ownership change of the Tax Group for purposes of Section 382. As a result, as indicated above, the entire amount of the estimated $17.7 billion NOL currently available to the Tax Group, substantially all of which is attributable to WMB, would be subject to the annual limitation imposed by section 382 of the IRC. In any event, as noted previously, even if there is no ownership change on the Effective Date, the current projected income of Reorganized WMI as reflected in the Projections (*see* Article VII) only utilizes a small portion of the estimated available NOL. In addition, it is possible there could be a subsequent ownership change after the Effective Date, which would further limit Reorganized WMI's NOLs (*see* Section VIII.A.2.a.).

(i) *General Section 382 Limitation*. In general, the amount of the annual limitation to which a corporation that undergoes an ownership change will be subject is equal to the product of (A) the fair market value of the stock of the corporation *immediately before* the ownership change (with certain adjustments) multiplied by (B) the "long term tax exempt rate" in effect for the month in which the ownership change occurs (*e.g.*, 3.55% for ownership changes occurring in December 2011, the most recently published long term tax exempt rate). For a corporation (or consolidated group) in bankruptcy that undergoes an ownership change pursuant to a confirmed bankruptcy plan, the fair market value of the stock of the corporation is generally determined immediately *after* (rather than before) the ownership change after giving effect to the discharge of creditors' claims, but subject to certain adjustments (including a reduction in stock value in the event the reorganized corporation has substantial investment assets); in no event, however, can the stock value for this purpose exceed the pre-change gross value of the corporation's assets. Any portion of the annual limitation that is not used in a given year may be carried forward, thereby adding to the annual limitation for the subsequent taxable year. Under certain circumstances not expected to be present here, the annual limitation otherwise computed may be increased if the corporation (or consolidated group) has an overall built-in gain in its assets at the time of the ownership change.

As indicated above, it is estimated that the amount of the annual limitation for Reorganized WMI as of the Effective Date will, at most, be only about $6 million per year (based on the estimated reorganized stock value, *see* Section I.C above). However, if the corporation (or consolidated group) does not continue its historic business or use a significant portion of its historic assets in a new business for at least two years after the ownership change, the annual limitation resulting from the ownership change is reduced to zero, thereby precluding any utilization of the corporation's pre-change losses (absent any increases due to recognized built-in gains). Historically, the Tax Group has been engaged in several businesses, including retail banking and financial services (*e.g.,* credit cards, lending to consumers and deposit taking activities), broker-dealer and investment advisory services, and insurance (*e.g.,* selling insurance-related products, including mortgage insurance, and participating in reinsurance activities with other insurance companies). Following the implementation of the Seventh Amended Plan involving a reorganization of WMI, the Tax Group intends to continue to be in the insurance business and possibly certain other historic lines of business, but will not provide retail banking and financial services (its historic primary line of business). There is no assurance whether such continuing activities of the Reorganized Debtors would satisfy the requisite level of continuing business activity. Moreover, the future conduct and direction of the business and operations of Reorganized WMI is not within the control of the Debtors, but will be determined by the new or continuing stockholders and the new management of Reorganized WMI. Accordingly, there is no assurance that even $6 million of the pre-change NOLs would be available to Reorganized WMI if the IRS were to determine that this continuity of business requirement was not met.

Section 382 of the IRC also limits the deduction of certain built-in losses recognized subsequent to the date of the ownership change. If a corporation (or consolidated group) has a net unrealized built-in loss at the time of an ownership change (taking into account most assets and items of built-in income, gain, loss and deduction), then any built-in losses recognized during the following five

years (up to the amount of the original net unrealized built-in loss) generally will be treated as pre-change losses and similarly will be subject to the annual limitation. Although the rule applicable to net unrealized built-in losses generally applies to consolidated groups on a consolidated basis, the IRS has recently proposed changes to the rule that would recompute the net unrealized built-in loss of the group upon a sale or disposition of the stock of a consolidated subsidiary, to take into account any disparity in built-in gain or loss between the stock and its share of the underlying assets.

The Debtors currently expect to, and the discussion herein assumes that the Debtors will, abandon their stock interest in WMB *prior* to the Effective Date. If the Stock Loss is recognized prior to (but in the same taxable year as) the Effective Date ownership change, the resulting NOL would be pro-rated between the pre- and post-change portions of the taxable year, such that the post-change portion would not be subject to the annual limitation resulting from the implementation of the Seventh Amended Plan (but would still be subject to at least partial reduction under the COD rules discussed above, to the extent that there is any COD). Based on a February 29, 2012 assumed Effective Date, the post-change portion would be approximately $5.4 billion[5] and would get proportionately smaller the later in the year the Effective Date occurs. Although not subject to the annual limitation resulting from the implementation of the plan, the post-change NOLs could nonetheless become subject to limitation in the event that Reorganized WMI undergoes another ownership change after the Effective Date, as discussed below.

If the Stock Loss is recognized *after* the Effective Date ownership change, it could be subject to limitation in its entirety as a recognized built-in loss (depending on whether the proposed changes to the net built-in loss rules, discussed above, have been finalized and their effective date), and thus rendered substantially unavailable, such that there is no assurance that the Stock Loss could be utilized to offset future income of the Reorganized Debtors.

(ii) *Risk of Subsequent Ownership Changes*. In an attempt to minimize the likelihood of an additional ownership change occurring after the Effective Date, the charter of Reorganized WMI will contain a restriction limiting the accumulation (and disposition) of shares by persons owning (actually or constructively), or who would own as a result of the transaction, 4.75% of any class of stock of Reorganized WMI (with certain adjustments). *See* Sections IX.B.3 and X.B.14 hereof. Nevertheless, it is possible that Reorganized WMI could undergo an additional ownership change, either by events within or outside of the control of the Board, *e.g.,* indirect changes in the ownership of persons owning 5% of the stock of Reorganized WMI. Also, in the event that the Second Lien Runoff Notes are recharacterized as equity of Reorganized WMI, transfers of such notes might be taken into account for purposes of section 382. Moreover, a substantial portion of the stock of Reorganized WMI may be reserved in respect of the Dime Warrants and Disputed Equity Interests (to the extent the Dime Warrant Litigation and such Disputed Equity Interests are not resolved by the Effective

[5] As stated, if the Stock Loss were recognized prior to (but in the same taxable year as) the Effective Date, the resulting NOL may be pro-rated on a daily basis between the pre- and post-change portions of the taxable year for purposes of applying the annual limitation imposed by section 382 of the IRC. If the Effective Date occurs on or about February 29, 2012, approximately 16.4% (calculated as the quotient of 60 days in 2012 as of February 29, 2012 divided by 366 total days in 2012), of the estimated $6.5 billion NOL (taking into account a pre-Effective Date Stock Loss, other deductions resulting from the implementation of the plan, and approximately $850 million of COD) would be allocated to the pre-change portion of the year, while the balance, or approximately 83.6% (calculated as 306 days remaining in 2012 as of February 29, 2012 divided by 366 total days), of such NOL would be allocated to the post-change portion of the year. Accordingly, the Debtors determined that approximately $5.4 billion of the NOL would not be subject to the $6 million annual limitation imposed by section 382 of the IRC, while the balance of such NOL, estimated to be approximately $1.1 billion, would be subject to the annual limitation.

Date) and additional Reorganized Common Stock could be reserved in respect of Disputed Claims. In such event, a subsequent release or transfer of the stock potentially could result in an ownership change of Reorganized WMI at that time. In the event of a subsequent ownership change, all or part of the NOLs that were previously unlimited could also become subject to an annual limitation, depending on, among other things, whether such ownership change occurs within the same taxable year as the Effective Date, the value of the stock of Reorganized WMI at the time of the ownership change, and whether Reorganized WMI has a net unrealized built-in gain at the time.

(iii) *Special Bankruptcy Exception*. An exception to the foregoing annual limitation rules generally applies where qualified (so-called "old and cold") creditors and existing shareholders of a debtor receive, in respect of their claims or equity interests, at least 50% of the vote and value of the stock of the reorganized debtor (or a controlling corporation if also in bankruptcy) pursuant to a confirmed chapter 11 plan. Under this exception, a debtor's pre-change losses are not limited on an annual basis but, instead, are required to be reduced by the amount of any interest deductions claimed during the three taxable years preceding the effective date of the reorganization, and during the part of the taxable year prior to and including the reorganization, in respect of all debt converted into stock in the reorganization. Moreover, if this exception applies, any further ownership change of the debtor within a two-year period after the consummation of the chapter 11 plan will preclude the debtor's utilization of any pre-change losses at the time of the subsequent ownership change against future income. Although it is unclear and depends on a number of factors, the Debtors do not anticipate that they would qualify for this exception. Moreover, even if they do qualify, the Debtors may, if they so desire, elect not to have the exception apply and instead remain subject to the annual limitation described above.

b. Other Provisions

Aside from the objective limitations of section 382 of the IRC, the IRS may disallow, pursuant to section 269 of the IRC, the subsequent use of a corporation's losses following an acquisition of control of a corporation by one or more persons if the principal purpose of the acquisition is the avoidance or evasion of tax by securing a tax benefit which such person(s) or the corporation would not otherwise enjoy. Accordingly, if the principal purpose of any group of persons (including creditors or Equity Interest holders) acquiring control of the Reorganized Debtors pursuant to the Seventh Amended Plan or afterwards is to obtain the use of the NOLs, the IRS could disallow the use of the full NOL (*i.e.*, *both* the pre-change portion that would be subject to the minimal annual limitation and the post-change unlimited portion, estimated to be approximately $5.4 billion based on a February 29, 2012 Effective Date). Other provisions of the IRC may also preclude the use of a corporation's NOLs and certain tax attributes in other ways under certain circumstances.

Significantly, the Bankruptcy Court in connection with the Confirmation Hearing on the Modified Sixth Amended Plan (upon which the Seventh Amended Plan is partially based) determined that, in its judgment, the creditors' receipt of Reorganized Common Stock thereunder was not for the principal purpose of tax avoidance within the meaning of section 269; however, the court recognized that such determination (which was made within the context of the portion of the hearing on valuation) was not binding on the IRS.

3. Debt Status of the Second Lien Runoff Notes

The proper tax characterization of the Second Lien Runoff Notes is subject to substantial uncertainty, because they are nonrecourse obligations of Reorganized WMI for which the sole source of payment is a portion of the Runoff Proceeds and based on the Projections the Runoff Proceeds will not be sufficient to pay principal and all accrued interest on the Second Lien Runoff Notes. Although the Debtors presently expect that Reorganized WMI will treat the Second Lien Runoff Notes as debt of

Reorganized WMI for U.S. federal income tax purposes, other characterizations of the Second Lien Runoff Notes are possible, such as equity of Reorganized WMI, a (non-debt) contract right or, perhaps, an ownership interest in WMMRC. Under certain possible recharacterizations, the NOLs of Reorganized WMI might not be available to offset the net income of WMMRC. There can be no assurance that the IRS would not be successful if it sought to recharacterize the Second Lien Runoff Notes as other than debt of Reorganized WMI. The remainder of this disclosure assumes that the Second Lien Runoff Notes are properly characterized as debt of Reorganized WMI for U.S. federal income tax purposes, unless otherwise indicated.

4. Alternative Minimum Tax

In general, a federal alternative minimum tax ("AMT") is imposed on a corporation's alternative minimum taxable income at a 20% tax rate to the extent such tax exceeds the corporation's regular federal income tax. For purposes of computing taxable income for AMT purposes, certain tax deductions and other beneficial allowances are modified or eliminated. For example, a corporation is generally not allowed to offset more than 90% of its taxable income for AMT purposes by available NOL carryforwards or carrybacks (although this limitation does not apply to AMT NOLs carried back or carried forward from the Debtor's 2008 taxable year).

In addition, if a corporation (or consolidated group) undergoes an "ownership change" within the meaning of section 382 of the IRC and is in a net unrealized built-in loss position (as determined for AMT purposes) on the date of the ownership change, the corporation's (or consolidated group's) aggregate tax basis in its assets would be reduced for certain AMT purposes to reflect the fair market value of such assets as of the change date.

Any AMT that a corporation pays generally will be allowed as a nonrefundable credit against its regular U.S. federal income tax liability in future taxable years when the corporation is no longer subject to the AMT and has a regular tax liability in excess of its computed AMT liability.

5. Transfer of Assets to the Liquidating Trust

Pursuant to the Seventh Amended Plan, on the Effective Date the Debtors will transfer the Liquidating Trust Assets (including all of the Debtors' right, title and interest in any tax refunds with respect to pre-2011 taxable years, but excluding the Debtors' economic interest in the Litigation Proceeds retained by Reorganized WMI as a result of Reorganized Common Stock Elections by certain Claimants) to the Liquidating Trust, on behalf of the respective claimants and holders of Equity Interests comprising the Liquidating Trust Beneficiaries. The transfer of assets by the Debtors pursuant to the Seventh Amended Plan may result in the recognition of gain or income by the Debtors, depending in part on the value of such assets on the Effective Date and the Debtors' tax basis in such assets. Subject to possible alternative minimum tax, and although not free from doubt, the Debtors anticipate that, in addition to any current year NOL incurred through the Effective Date of the Seventh Amended Plan, the NOL carryforwards of the Tax Group generally should be available to offset any gain or income recognized upon transfer of assets pursuant to the Seventh Amended Plan. Due to the lack of guidance with respect to the sale or other taxable disposition of a tax refund claim or suit for refund, there is no assurance that a subsequent resolution of the claim or suit could not result in additional income to the Debtors or Reorganized Debtors, which may or may not be able to be offset by the existing NOL carryforwards of the Tax Group.

B. Consequences to Holders of Certain Claims and Equity Interests

Pursuant to the Seventh Amended Plan, and in satisfaction of their respective Claims, it is contemplated that holders of Allowed Convenience Claims and Allowed Priority Non-Tax Claims will receive cash, and holders of Allowed Senior Notes Claims, Allowed Senior Subordinated Notes Claims, Allowed General Unsecured Claims, Allowed CCB-1 Guarantee Claims, Allowed CCB-2 Guarantee Claims, Allowed PIERS Claims and certain late-filed claims, will receive cash, Liquidating Trust Interests, Runoff Notes and/or Reorganized Common Stock (depending on the particular class and applicable elections).

Pursuant to the Seventh Amended Plan, those holders of WMB Senior Notes Claims in Class 17A that are deemed to grant releases by virtue of their elections with respect to the Modified Sixth Amended Plan (in which case their Claims are treated as Allowed Claims) or have their Claims otherwise allowed will receive their pro rata share of BB Liquidating Trust Interests in satisfaction of their Claims.

Releasing REIT Trust Holders will also receive a separately negotiated payment from JPMC under the Global Settlement Agreement, the tax consequences of which are not discussed herein.

Pursuant to the Seventh Amended Plan, holders of Subordinated Claims will receive their contingent Pro Rata Share of Liquidating Trust Interests and their Claims will be extinguished. Holders of Preferred Equity Interests (including, without limitation, each holder of a REIT Series), Common Equity Interests (including Disputed Equity Interests to the extent determined to be Equity Interests or Allowed Claims subordinated to the level of Equity Interests) and Dime Warrants (to the extent determined to be Equity Interests or Allowed Claims subordinated to the level of Equity Interests) will receive their contingent Pro Rata Share of Liquidating Trust Interests and the amount of Reorganized Common Stock allocated to such Class, subject to the provision of the releases described in Section 41.6 of the Seventh Amended Plan, and their Equity Interests or Allowed Claims will be extinguished.

The U.S. federal income tax consequences of the Seventh Amended Plan to holders of Claims, including the character, amount and timing of income, gain or loss recognized as a consequence of the Seventh Amended Plan and the distributions provided for by the Seventh Amended Plan, generally will depend upon, among other things, (i) the manner in which a holder acquired a Claim; (ii) the length of time a Claim has been held; (iii) whether the Claim was acquired at a discount; (iv) whether the holder has taken a bad debt deduction in the current or prior years; (v) whether the holder has previously included accrued but unpaid interest with respect to a Claim; (vi) the holder's method of tax accounting; (vii) whether the holder will realize foreign currency exchange gain or loss with respect to a Claim; (viii) whether a Claim is an installment obligation for federal income tax purposes; and (ix) whether the transaction is treated as a "closed transaction." Therefore, holders of Claims are urged to consult their tax advisors for information that may be relevant to their particular situation and circumstances and the particular tax consequences to such holders as a result thereof.

In addition, pursuant to the Seventh Amended Plan, certain qualifying Claim and Equity Interest holders may choose to become a lender under the Credit Facility, in replacement (in whole or in part) of AAOC. The following discussion assumes that the right of such holders to become lenders does not constitute additional consideration in respect of their Claims or Equity Interest. Any holder considering participating in the Credit Facility should consult its tax advisor regarding the federal income tax consequences of becoming, and being, a lender under the Credit Facility. Such consequences are not discussed herein.

1. Allowed Convenience Claims and Priority Non-Tax Claims

In general, each holder of an Allowed Convenience Claim or Priority Non-Tax Claim will recognize gain or loss in an amount equal to the difference between (i) the amount of cash received by such holder in satisfaction of its Claim (other than any amounts received in respect of a Claim for accrued but unpaid interest) and (ii) the holder's adjusted tax basis in its Claim (other than any Claim for accrued but unpaid interest). Where gain or loss is recognized by a holder, the character of such gain or loss as long-term or short-term capital gain or loss or as ordinary income or loss will be determined by a number of factors, including the tax status of the holder, whether the Claim constitutes a capital asset in the hands of the holder and how long it has been held, whether the Claim was acquired at a market discount, and whether and to what extent the holder previously had claimed a bad debt deduction.

For a discussion of the treatment of any Claim for accrued but unpaid interest, *see* Section VIII.B.2.c, *"Distributions in Discharge of Accrued Interest,"* below.

2. Certain Unsecured Claims, Subordinated Claims and Equity Interests

Pursuant to the Seventh Amended Plan, holders of certain Allowed Claims and Subordinated Claims will receive cash, Liquidating Trust Interests, Runoff Notes and/or Reorganized Common Stock (subject to certain elections and adjustments), in partial or full satisfaction of their respective Claims; and holders of Equity Interests (including Dime Warrants and Disputed Equity Interests to the extent determined to be Equity Interests or Allowed Claims subordinated to the level of Equity Interests) will receive contingent Liquidating Trust Interests and Reorganized Common Stock, subject to the provision of the releases described in Section 41.6 of the Seventh Amended Plan.

As discussed below (*see* Section VIII.C, "*Tax Treatment of Liquidating Trust and Holders of Beneficial Interests"*), the Liquidating Trust has been structured to qualify as a "grantor trust" for U.S. federal income tax purposes. Accordingly, each holder of an Allowed Claim, Subordinated Claim or Equity Interest receiving a beneficial interest in the Liquidating Trust will be treated for U.S. federal income tax purposes as directly receiving, and as a direct owner of, its respective share of the Liquidating Trust Assets (consistent with its economic rights in the trust), or in the case of the holder of an Allowed WMB Senior Notes Claim, as a direct owner of a fixed undivided interest in the Homeownership Carryback Refund Amount. Pursuant to the Seventh Amended Plan, the Debtors or the Liquidating Trustee (as provided in the Seventh Amended Plan) will in good faith value the assets transferred to the Liquidating Trust, and all parties to the Liquidating Trust (including holders of Claims and Equity Interests receiving Liquidating Trust Interests) must consistently use such valuation for all U.S. federal income tax purposes.

After the Effective Date, a holder's share of any collections received on the assets of the Liquidating Trust (other than as a result of the subsequent disallowance of Disputed Claims, or the redistribution among holders of Allowed Claims or Equity Interests of undeliverable distributions) should not be included, for federal income tax purposes, in the holder's amount realized in respect of its Claim or Equity Interest but should be separately treated as amounts realized in respect of such holder's ownership interest in the underlying assets of the Liquidating Trust. *See* Section VIII.C, "*Tax Treatment of Liquidating Trust and Holders of Beneficial Interests*," below.

The U.S. federal income tax consequences to a holder of an Allowed Claim who receives Runoff Notes or Reorganized Common Stock also depend, in part, on whether such Claim or Runoff Notes constitutes a "security" of Reorganized WMI for U.S. federal income tax purposes. The term "security" is not defined in the IRC or in the Treasury regulations issued thereunder and has not been clearly defined by judicial decisions. The determination of whether a particular debt obligation constitutes a "security" depends on an overall evaluation of the nature of the debt, including whether the holder of such debt obligation is subject to a material level of entrepreneurial risk and whether a continuing proprietary interest is intended or not. One of the most significant factors considered in determining whether a particular debt is a "security" is its original term. In general, debt obligations issued with a weighted average maturity at issuance of five years or less (*e.g.*, trade debt and revolving credit obligations) do not constitute "securities," whereas debt obligations with a weighted average maturity at issuance of ten years or more constitute "securities." Accordingly, certain Allowed Claims and Subordinated Claims may qualify as "securities" while others may not. The U.S. federal income tax treatment of the Runoff Notes, which have an expected weighted average life between five years and 10 years, is unclear. Although the debt status of the Second Lien Runoff Notes is uncertain (*see* Section VIII.A.3, "*Debt Status of the Second Lien Runoff Notes*," above), the Debtors expect that Reorganized WMI will treat the Runoff Notes as securities of Reorganized WMI; accordingly, the remainder of this disclosure assumes the Runoff Notes are securities of Reorganized WMI. You are urged to consult your own tax advisor regarding the characterization as securities for U.S. federal income tax purposes of your Claim and/or the Runoff Notes and the consequences of such treatment.

a. Gain or Loss – In General

Unless an Allowed Claim constitutes a "security" and qualifies for recapitalization treatment (as discussed in the next section), the exchanging holder generally will recognize gain or loss (although any loss with respect to such a Claim might be deferred until all Disputed Claims are resolved) in an amount equal to the difference, between (i) the sum of the amount of any cash, the issue price of the Runoff Notes, and the fair market value of all other consideration received (other than any amounts received in respect of any Claim for accrued but unpaid interest) and (ii) the holder's adjusted tax basis in its Claim (other than any tax basis attributable to accrued but unpaid interest). In determining the consideration received by a holder, it is possible that the holders of certain Claims may be treated as having received on account of their Claims, Cash or Reorganized Common Stock and then effectively exchanged such Cash or Reorganized Common Stock for releases. If so, such holder should recognize a loss with respect to the amount paid for such release that would generally have the same character as the corresponding gain or loss of such holder with respect to the initial receipt of such amount on account of such holder's Claim.

In the case of a holder of a deferred compensation or other wage claim, the consideration received in satisfaction of such claim (whether in cash or in property value) will be includable by the holder as compensation income to the extent not previously included, and will be subject to applicable withholding. Because the larger portion of the consideration received by a holder of a wage claim may not be cash and thus the cash portion may be insufficient to satisfy the applicable wage withholding, the holder may be required to provide the cash necessary to satisfy any shortfall as a condition to receiving any distribution.

In the case of holders of Equity Interests (including Dime Warrants and Disputed Equity Interests to the extent determined to be Equity Interests or Allowed Claims subordinated to the level of Equity Interests), the Seventh Amended Plan provides that such holders will receive Reorganized Common Stock only if they grant the releases described in Section 41.6 of the Seventh Amended Plan. Accordingly, it is uncertain whether, for federal income tax purposes, the receipt of Reorganized Common Stock by such holders would be viewed as eligible for the recapitalization treatment described

below or, alternatively, as a fully taxable transaction, in which case, the character, timing and amount of income, gain or loss to such holder could depend on whether the Reorganized Common Stock is viewed as being received from certain creditors in exchange for releases rather than from Reorganized WMI in respect of the Equity Interests of such holders. *Holders of Equity Interests should consult their tax advisors regarding the possible consequences of their receipt of Reorganized Common Stock pursuant to the Seventh Amended Plan*.

After the Effective Date, a holder's share of any collections received on the assets of the Liquidating Trust (other than as a result of the subsequent disallowance of Disputed Claims or the redistribution among holders of Allowed Claims or Equity Interests of undeliverable distributions), should not be included, for federal income tax purposes, in the holder's amount realized in respect of its Allowed Claim or Equity Interest but should be separately treated as amounts realized in respect of such holder's ownership interest in the underlying assets of the Liquidating Trust. *See* Section VIII.C, "*Tax Treatment of Liquidating Trust and Holders of Beneficial Interests*," below.

In the event of a subsequent disallowance of a Disputed Unsecured Claim, it is possible that a holder of a previously Allowed Claim or Equity Interest may be taxed as such Disputed Claims or dispute are resolved and the holder effectively becomes entitled to an increased share of the assets held in the Liquidating Trust. The imputed interest provisions of the IRC may apply to treat a portion of such increased share or any additional distributions (*e.g.,* the redistribution among holders of Allowed Claims of undeliverable distributions) as imputed interest. In addition, it is possible that any loss realized by a holder in satisfaction of an Allowed Claim or Equity Interest may be deferred until all Disputed Claims in such holder's class are determined and such holder's share can no longer increase, and with respect to certain claims, that a portion of any gain realized may be deferred under the "installment method" of reporting. Holders are urged to consult their tax advisors regarding the possibility for deferral, and the ability to elect out of the installment method of reporting any gain realized in respect of their Claims or Equity Interests.

A holder's aggregate tax basis in any Runoff Notes, Reorganized Common Stock and/or undivided interest in the Liquidating Trust received in satisfaction of a Claim that does not constitute a security will equal the amount taken into account in respect of such notes, stock or undivided interest in determining the holder's amount realized. A holder's holding period in such notes, stock or undivided interest generally will begin the day following the Effective Date.

b. Recapitalization Treatment

The receipt of any Runoff Notes (if the Runoff Notes constitute securities of Reorganized WMI) or Reorganized Common Stock in partial satisfaction of an Allowed Claim that constitutes a "security" for U.S. federal income tax purposes or an Equity Interest generally would qualify as a "recapitalization" for U.S. federal income tax purposes (unless possibly, as indicated above with respect to Equity Interests including Dime Warrants and Disputed Equity Interests to the extent determined to be Equity Interests or Allowed Claims subordinated to the level of Equity Interests, the Reorganized Common Stock is treated as having been received from certain creditors in exchange for releases rather than from Reorganized WMI). In such event, each such holder generally will not recognize any loss upon the exchange of its Claim or Equity Interest, but will recognize any gain (computed as discussed in the preceding section) to the extent of any cash and the fair market value of its undivided interest in the Liquidating Trust Assets received (other than to the extent received in respect of a Claim for accrued but unpaid interest, or attributable to the receipt of Runoff Notes, if the Runoff Notes constitute securities of Reorganized WMI). The treatment of distributions in respect of a Claim for accrued but unpaid interest is discussed in the next section.

In a recapitalization exchange, a holder's aggregate tax basis in any Runoff Notes (if the Runoff Notes constitute securities of Reorganized WMI) or Reorganized Common Stock received in respect of an Allowed Claim that constitutes a security or an Equity Interest will equal the holder's adjusted tax basis in such Claim or Equity Interest (including any Claim for accrued but unpaid interest), increased by any gain recognized or interest income received in respect of such Claim or Equity Interest, and decreased by the amount of any cash and the fair market value of any share of the Liquidating Trust Assets (other than Runoff Notes, if the Runoff Notes constitute securities of Reorganized WMI) received and any deductions claimed in respect of any previously accrued but unpaid interest. With respect to recipients of both Runoff Notes (if the Runoff Notes constitute securities of Reorganized WMI) and Reorganized Common Stock, the aggregate tax basis presumably should be allocated among any Runoff Notes and Reorganized Common Stock in accordance with their relative fair market values. In a recapitalization exchange, a holder's holding period in any Runoff Notes (if the Runoff Notes constitute securities of Reorganized WMI) and Reorganized Common Stock received will include the holder's holding period in the Claim or Equity Interest exchanged therefor, except to the extent of any exchange consideration received in respect of a Claim for accrued but unpaid interest (which will commence a new holding period).

A holder's tax basis in its undivided interest in the Liquidating Trust Assets will equal the fair market value of such interest, and the holder's holding period generally will begin the day following the Effective Date.

c. Distributions in Discharge of Accrued Interest

In general, to the extent that any consideration received pursuant to the Seventh Amended Plan (whether cash, stock or other property) by a holder of a Claim is received in satisfaction of interest accrued during its holding period, such amount will be taxable to the holder as interest income (if not previously included in the holder's gross income). Conversely, a holder should generally recognize a deductible loss to the extent any accrued interest or amortized original issue discount ("OID") was previously included in its gross income and is not paid in full. However, the IRS has privately ruled that a holder of a "security" of a corporate issuer, in an otherwise tax-free exchange, could not claim a current ordinary deduction with respect to any unpaid OID. Accordingly, it is also unclear whether, by analogy, a holder of a Claim that does not constitute a security would be required to recognize a capital loss, rather than an ordinary loss, with respect to previously included OID that is not paid in full.

The Seventh Amended Plan provides that consideration received in respect of a Claim is allocable first to the principal amount of the Claim (as determined for U.S. federal income tax purposes) and then, to the extent of any excess, to the remainder of the Claim, including any Claim for accrued but unpaid interest (in contrast, for example, to a pro rata allocation of a portion of the exchange consideration received between principal and interest, or an allocation first to accrued but unpaid interest). *See* Section 31.11 of the Seventh Amended Plan. There is no assurance that the IRS will respect such allocation for U.S. federal income tax purposes. You are urged to consult your own tax advisor regarding the allocation of consideration received under the Seventh Amended Plan, as well as the deductibility of accrued but unpaid interest and the character of any loss claimed with respect to accrued but unpaid interest previously included in gross income for U.S. federal income tax purposes.

d. Character of Gain or Loss

Where gain or loss is recognized by a holder in respect of its Allowed Claim or Equity Interest, the character of such gain or loss as long-term or short-term capital gain or loss or as ordinary income or loss will be determined by a number of factors, including, among others, the tax status of the holder, whether the Claim or Equity Interest constitutes a capital asset in the hands of the holder and how

long it has been held, and whether and to what extent the holder had previously claimed a bad debt deduction in respect of such Claim. A reduced tax rate on long-term capital gain may apply to non-corporate holders. The deductibility of capital loss is subject to significant limitations; *see* Section VIII.B.2.e, "*Limitations on Capital Losses*," below.

In addition, a holder that purchased its Claims from a prior holder at a "market discount" (relative to the principal amount of the Claims at the time of acquisition) may be subject to the market discount rules of the IRC. In general, a debt instrument is considered to have been acquired with "market discount" if its holder's adjusted tax basis in the debt instrument is less than (i) its stated principal amount or (ii) in the case of a debt instrument issued with OID, its adjusted issue price, in each case, by at least a *de minimis* amount. Under the market discount rules, any gain recognized on the exchange of Claims (other than in respect of a Claim for accrued but unpaid interest) generally will be treated as ordinary income to the extent of the market discount accrued (on a straight line basis or, at the election of the holder, on a constant interest basis) during the holder's period of ownership, unless the holder elected to include the market discount in income as it accrued. If a holder of Claims did not elect to include market discount in income as it accrued and thus, under the market discount rules, was required to defer all or a portion of any deductions for interest on debt incurred or maintained to purchase or carry its Claims, such deferred amounts would become deductible at the time of the exchange, up to the amount of gain that the holder recognizes in the exchange.

In the case of an exchange of Claims that qualifies as a recapitalization, the IRC indicates that any accrued market discount in respect of the Claims in excess of the gain recognized in the exchange should not be currently includible in income under Treasury regulations to be issued. However, such accrued market discount should carry over to any non-recognition property received in exchange therefor (*i.e.*, to any Runoff Notes, if the Runoff Notes constitute securities of Reorganized WMI, subject to the application of the Contingent Payment Regulations discussed below, and Reorganized Common Stock received). To date, specific Treasury regulations implementing this rule have not been issued.

e. Limitations on Capital Losses

A holder of a Claim or Equity Interest who recognizes a capital loss as a result of the distributions under the Seventh Amended Plan will be subject to limits on the use of such capital loss. For a non-corporate holder, capital losses may be used to offset any capital gains (without regard to holding periods), and also ordinary income to the extent of the lesser of (1) $3,000 ($1,500 for married individuals filing separate returns) or (2) the excess of the capital losses over the capital gains. A non-corporate holder may carry over unused capital losses and apply them against future capital gains and a portion of their ordinary income for an unlimited number of years. For corporate holders, capital losses may only be used to offset capital gains. A corporate holder that has more capital losses than may be used in a tax year may carry back unused capital losses to the three taxable years preceding the capital loss year, and may carry over unused capital losses for the five taxable years following the capital loss year.

3. Ownership and Disposition of Runoff Notes

a. Debt Status of the Runoff Notes

Reorganized WMI will treat the First Lien Runoff Notes, and the Debtors expect that Reorganized WMI will treat the Second Lien Runoff Notes, as debt for U.S. federal income tax purposes. Holders of Runoff Notes will be required to treat the Runoff Notes consistent with Reorganized WMI's treatment, unless they disclose any inconsistent treatment on their tax returns. As previously discussed, the proper characterization of the Second Lien Runoff Notes is subject to substantial uncertainty and it is

possible that the Second Lien Runoff Notes may be recharacterized as other than debt (*e.g.*, as equity of Reorganized WMI or an ownership interest in WMMRC). In that case, the consequences of the receipt, ownership and disposition of the Second Lien Runoff Notes will materially differ from the discussion herein. Holders of Second Lien Runoff Notes are urged to consult their tax advisors with respect to such potential recharacterization. The discussion herein assumes that the Second Lien Runoff Notes (as well as the First Lien Runoff Notes) are respected as debt for federal income tax purposes.

b. Uncertainty regarding Characterization of Runoff Notes as Contingent Payment Debt Instruments

Introduction. Because interest on the Runoff Notes is subject to deferral, the Runoff Notes will be treated for U.S. federal income tax purposes as issued with original issue discount ("OID"), and holders are required to include OID in income for U.S. federal income tax purposes prior to the receipt of cash payments attributable to such income. It is uncertain, however, whether or not the determination of OID on the Runoff Notes will be governed by certain Treasury regulations (the "Contingent Payment Regulations") that generally provide for the treatment of debt instruments with one or more contingent payments. Moreover, on the date hereof, the Debtors are unable to state whether they expect Reorganized WMI will report the Runoff Notes as subject to the Contingent Payment Regulations. This determination will depend in part on the "issue price" of the Runoff Notes and on certain other features of the notes.

The issue price (as determined under the OID rules) is significant because if the issue price for a class of Runoff Notes is not its face amount, the yield on such notes for OID purposes will vary depending on the timing of payments on the notes, and such variation in yield might cause the notes to be subject to the Contingent Payment Regulations. If a class of Runoff Notes are treated as publicly traded under the OID rules or a substantial portion of such class of notes are issued in exchange for property which is publicly traded, the issue price of such notes will be their fair market value on the Effective Date. Otherwise, when public trading is not present, the issue price will be the face amount of such class of Runoff Notes, unless the notes are nevertheless governed by the Contingent Payment Regulations, in which case, the issue price of such notes will be their fair market value on the Effective Date.

If Reorganized WMI concludes that the issue price for the First Lien Runoff Notes is likely their face amount, the Debtors anticipate that Reorganized WMI likely would treat such notes as not governed by the Contingent Payment Regulations. In contrast, the Debtors are unable to predict Reorganized WMI's treatment with respect to the Second Lien Runoff Notes in a similar circumstance. If Reorganized WMI concludes that a class of Runoff Notes likely has an issue price other than their face amount, the Debtors anticipate that Reorganized WMI likely would treat such notes as governed by the Contingent Payment Regulations. It should be emphasized that the determination whether to treat a class of Runoff Notes as governed by the Contingent Payment Regulations will be made based on the relevant facts as of the Effective Date by Reorganized WMI, together with its tax advisors and tax return preparer; accordingly, such treatment may be different from the Debtors' current expectations.

Determining Whether the Runoff Notes are "Publicly Traded". A class of Runoff Notes will have an issue price for purposes of the OID rules equal to their fair market value on the Effective Date if either (1) such Runoff Notes are traded ("publicly traded") on an "established securities market" during the sixty-day period ending thirty days after the Effective Date or (2) a substantial amount of the such Runoff Notes are issued in exchange for other debt instruments, stock or securities (*e.g.*, the Senior Subordinated Notes, PIERS Common Securities and PIERS Preferred Securities) that are so traded. For this purpose, an "established securities market" includes, among other things, (i) a system of general circulation (including a computer listing disseminated to subscribing brokers, dealers, or traders) that

provides a reasonable basis to determine fair market value by disseminating either recent price quotations or actual prices of recent sales transactions, and (ii) the ready availability of price quotations from dealers, brokers or traders (subject to certain exceptions).

In January 2011, the IRS proposed new Treasury regulations to determine when property is considered to be traded on an established securities market. Under these proposed regulations, the sixty-day testing period is reduced to thirty days, but otherwise generally it is significantly more likely that property will be treated as traded on an established securities market than under the currently applicable Treasury regulations. If promulgated, the new regulations would be effective for debt instruments issued on or after the date that final regulations are promulgated. It is uncertain whether these proposed regulations will be finalized before the Effective Date and what changes, if any, may be made in the final regulations.

It is presently uncertain whether either class of Runoff Notes, or the Claims treated as exchanged for Runoff Notes, will be considered as publicly traded and, accordingly, whether either class of Runoff Notes would have a fair market value issue price. Holders are urged to consult their tax advisors with respect to the federal income tax treatment of the ownership and disposition of each class of Runoff Notes

A summary of the OID calculations and inclusions, and gain or loss determination upon disposition for the Runoff Notes is set forth below in separate sections for notes not subject to the Contingent Payment Regulations and notes subject to such regulations.

c. Runoff Notes Not Subject to the Contingent Payment Regulations.

This section is applicable to Runoff Notes *not* subject to the Contingent Payment Regulations.

<u>*OID Calculations and Inclusions*</u>. The OID on a class of Runoff Notes that is not subject to the Contingent Payment Regulations will be an amount equal to the excess of the "stated redemption price at maturity" of such Runoff Notes over their "issue price." For purposes of the foregoing, the general rule is that the stated redemption price at maturity of a debt instrument is the sum of all payments provided by the debt instrument other than payments of "qualified stated interest." None of the stated interest on the Runoff Notes is qualified stated interest since it is not unconditionally payable in cash or in property (other than debt instruments of the issuer) at least annually at a single fixed rate. Thus, interest payable on the Runoff Notes will be included in the stated redemption price at maturity and taxed as OID.

Each holder of a Runoff Note will be required to include in its gross income, as interest for U.S. federal income tax purposes, the portion of the OID that accrues while the holder held the note (including the day the note is acquired but excluding the day it is disposed of), *regardless of* such holder's normal method of accounting. Any OID will accrue over the term of the Runoff Note based on the constant interest method (with the amount of OID attributable to each accrual period allocated ratably to each day in such period). Accordingly, a holder may be required to recognize income prior to the receipt of cash payments attributable to such income.

A holder's tax basis in a Runoff Note that is not subject to the Contingent Payment Regulations will be increased by the amount of any OID included in its gross income and reduced by any payments of cash made with respect to such note. Payments on a Runoff Note will be treated first as a payment of accrued OID then as a payment of principal.

The rules regarding OID are complex and the rules described above may not apply in all cases. Accordingly, you should consult your own tax advisors regarding their application.

Sale, Exchange or Other Taxable Disposition of Runoff Notes. Unless a non-recognition provision applies, a holder of a Runoff Note that is not governed by the Contingent Payment Regulations generally will recognize gain or loss upon the sale, exchange or redemption of a Runoff Note equal to the difference, if any, between the holder's adjusted tax basis in the note and the amount realized on the sale, exchange or redemption. For this purpose, a holder's adjusted tax basis in a Runoff Note generally will equal the holder's initial tax basis in the note, increased by the amount of any OID accrued on the note (determined without adjustments) up through the date of the sale, exchange, or redemption, and decreased by the amount of any cash payments. Any gain or loss generally will be capital gain or loss (subject to the market discount rules discussed below). *See* Section VIII.B.2.2.e, "*Limitations on Capital Losses*," above.

Acquisition Premium/Market Discount. It is possible that a holder of a Claim will have a tax basis in a Runoff Note received in respect of its Claim different than the issue price of such note, such as because the Runoff Note is considered a security and is received in exchange for a Claim that is considered a security. If a holder has a tax basis in a Runoff Note that is not subject to the Contingent Payment Regulations that *exceeds* the issue price of such note, but is *less than or equal to* the sum of all remaining amounts payable under such note, the amount of OID includible in the holder's gross income generally is reduced in each period in proportion to the percentage of the OID represented by the excess basis.

Any holder that has a tax basis in a Runoff Note that is not subject to the Contingent Payment Regulations that *is less than* the issue price of such note generally will be subject to the market discount rules of the IRC (subject to a *de minimis* exception and an exception for notes received at original issue in a reorganization in exchange for securities that were not themselves market discount bonds). Under the market discount rules, a holder is required to treat any principal payment on, or any gain recognized on the sale, exchange, retirement or other disposition of, a note as ordinary income to the extent of the market discount that has not previously been included in income and is treated as having accrued on such note at the time of such payment or disposition. A holder could be required to defer the deduction of a portion of the interest expense on any indebtedness incurred or maintained to purchase or to carry a market discount note, unless an election is made to include all market discount in income as it accrues. Such an election would apply to all bonds acquired by the holder on or after the first day of the first taxable year to which such election applies, and may not be revoked without the consent of the IRS.

Any market discount will be considered to accrue on a straight-line basis during the period from the date of acquisition of such note to the maturity date of the note, unless the holder irrevocably elects to compute the accrual on a constant yield basis. This election can be made on a note-by-note basis. In the case of the Runoff Notes, principal payments are expected to be made prior to their stated maturity dates and, although not addressed in IRS administrative guidance, calculating the accrual of market discount by reference to the expected timing of principal payments would seem more appropriate than by reference to the stated maturity dates of the Runoff Notes.

d. Runoff Notes Subject to the Contingent Payment Regulations

This section is applicable to Runoff Notes that *are* subject to the Contingent Payment Regulations. A different set of rules under the Contingent Payment Regulations apply to Runoff Notes where public trading is present (because either the notes or the property exchanged for the notes are traded on an established securities market as described above in Section VIII.B.3.b) than where public

trading is not present. The rules applicable to where there is public trading are discussed first, and then the rules applicable where there is no public trading.

(i) Runoff Notes Where Public Trading Is Present

OID Calculations and Inclusions. Where there is public trading in connection with the issuance of a class of Runoff Notes, under the applicable Contingent Payment Regulations, WMI must construct a projected payment schedule for such class of Runoff Notes and holders generally must recognize all interest income with respect to such notes on a constant yield basis based on this projected payment schedule for such class, subject to certain adjustments if actual contingent payments differ from those projected. In particular, each projected payment schedule will be determined by including the "expected value," as of the issue date, of the projected payments of principal and interest for the related class of Runoff Notes, adjusted, as necessary, so that the projected payments discounted at the "comparable yield," which is the yield at which WMI would issue a fixed rate debt instrument with terms and conditions similar to those of the related class of Runoff Notes, equals the issue price for such Runoff Notes.

The amount of interest that is treated as accruing each accrual period on a Runoff Note is the product of the "comparable yield" and the Runoff Note's "adjusted issue price" at the beginning of each accrual period. The "adjusted issue price" of a Runoff Note is the issue price of the note, increased by interest previously accrued on the note (determined without adjustments for differences between the projected payment schedule and the actual payments on the note), and decreased by the amount of any noncontingent payments and the projected amount of any contingent payments previously made on the note.

Except for adjustments made for differences between actual and projected payments, the amount of interest included in income by a holder of a Runoff Note is the portion that accrues while the holder holds such note (with the amount attributable to each accrual period allocated ratably to each day in such period). If actual payments differ from projected payments, then holders generally will be required in any given taxable year either to include additional interest in gross income (in case the actual payments exceed projected payments in such taxable year) or to reduce the amount of interest income otherwise accounted for on the Runoff Note (in case the actual payments are less than the projected payments in such taxable year). If the negative adjustment exceeds the interest for the taxable year that otherwise would have been accounted for on the notes, the excess will be treated as ordinary loss. However, the amount treated as an ordinary loss in any taxable year is limited to the amount by which the holder's total interest inclusions on the Runoff Note exceed the total amount of the net negative adjustments treated as ordinary loss in prior taxable years. Any remaining excess will be a negative adjustment carryforward and treated as a negative adjustment in the succeeding year. If a Runoff Note is sold, exchanged, or retired, any negative adjustment carryforward from the prior year will reduce the holder's amount realized on the sale, exchange or retirement.

The yield, timing and amounts set forth on the projected payment schedules are for U.S. federal income tax purposes only and are not assurances by us with respect to any aspect of the Runoff Notes. Any holder may obtain the comparable yield, the projected payment schedule, the issue price, the amount of OID, and the issue date for each class of Runoff Notes of the notes by writing to Reorganized WMI. For U.S. federal income tax purposes, a holder must use the comparable yield and projected payment schedule for a Runoff Note in determining the amount and accrual of OID on such note, unless the holder explicitly discloses in accordance with the Contingent Payment Regulations its differing position. The IRS is not bound by such schedule and will not respect a projected payment schedule which it determines to be unreasonable

It is possible that a holder of a Runoff Note will have a tax basis in its Runoff Note received in respect of their Claims that is different from the adjusted issue price of such notes. In such case a holder must reasonably allocate any difference between the adjusted issue price and the basis to accruals of interest or projected payments over the term of the note. If basis is *greater* than the adjusted issue price, the adjustment is a negative adjustment to accruals of interest or projected payments and on the date of adjustment will reduce the holder's adjusted basis by the amount treated as a negative adjustment. If basis is *less* than the adjusted issue price, the adjustment is a positive adjustment to accruals of interest or projected payments and on the date of adjustment will increase the holder's adjusted basis by the amount treated as a positive adjustment. Under the Contingent Payment Regulations, the premium and market discount rules do not apply to the Runoff Notes.

Sale, Exchange or Other Taxable Disposition of Runoff Notes Where Public Trading Is Present. Where a Runoff Note is subject to the Contingent Payment Regulations and public trading was present in connection with the issuance of such class of Runoff Notes, unless a non-recognition provision applies, a holder generally will recognize gain or loss upon the sale, exchange or redemption of such Runoff Note equal to the difference, if any, between the holder's adjusted tax basis in the note and the amount realized on the sale, exchange or redemption (with any negative adjustment carryforward from the prior year reducing the holder's amount realized). Under the Contingent Payment Regulations, any gain recognized on a sale, redemption or other taxable disposition of a Runoff Note will be ordinary interest income and any loss will be an ordinary loss to the extent the holder's total interest inclusions on a note exceed the total amount of ordinary loss the holder took into account with respect to differences between actual payments and projected payments (any additional loss generally will be capital loss). *See* Section VIII.B.2.e "*Limitations on Capital Losses*," above.

For purposes of computing gain or loss, a holder's adjusted tax basis in a Runoff Note generally will equal the holder's initial tax basis in the note, increased by the amount of any OID accrued on the note (determined without certain adjustments) up through the date of the sale, redemption or taxable disposition, and decreased by the amount of any payments projected to have been previously made on the note.

(ii) Runoff Notes Where No Public Trading Is Present

OID Calculations and Inclusions. Where there is no public trading in connection with the issuance of a class of Runoff Notes, the amount realized with respect to the receipt of a Runoff Note by a holder upon the exchange of its Claims should equal the fair market value of the Runoff Note (rather than their issue price) under the Contingent Payment Regulations.

The Runoff Notes will not technically have an issue price and, for purposes of calculating OID, the amount treated as OID with respect to such Runoff Notes is treated as not determinable until the time that actual payments are made. When payments are made with respect to a Runoff Note, the amount of OID is the difference between the amount of the payment and the amount of such payment determined

to constitute a return of principal. The portion of such payment constituting principal is determined by discounting the payment back to the issue date of such Runoff Note, using the applicable federal rate under Section 1274(d) of the IRC that would have been in effect for such Runoff Note if the term of such Runoff Note began on the issue date (i.e., the Effective Date) and ended on the date the payment is made. The amount of OID is includable at such time as interest in the holder's gross income. The principal amount of the payment will be applied to reduce the holder's basis in such Runoff Note with any excess treated as gain from the sale or exchange of the obligation. Under the Contingent Payment Regulations, the premium and market discount rules would not apply to the Runoff Notes.

Sale, Exchange or Other Taxable Disposition of Runoff Notes Where No Public Trading Is Present. Upon the sale, exchange or redemption of a Runoff Note subject to the Contingent Payment Regulations where public trading was not present in connection with the issuance of such class of Runoff Notes, unless a non-recognition provision applies, the amount received by a holder of such Runoff Note would be treated as if it were a payment on such Runoff Note and would be characterized as principal and interest in the same manner as the payments described in the preceding paragraph.

The Contingent Payment Regulations are complex and their application to the Runoff Notes is uncertain. Holders are strongly urged to consult their tax advisors with respect to the application of the Contingent Payment Regulations to the Runoff Notes.

e. Application of AHYDO Provisions to the Runoff Notes

It is anticipated that the Runoff Notes will be subject to the applicable high yield discount obligation ("AHYDO") provisions, which would disallow permanently a portion of the interest deductions on the Runoff Notes, and would defer Reorganized WMI's deductions for interest expense on the Runoff Notes until actually paid. The "disqualified portion" of the interest deduction is generally the portion of the interest on the Runoff Notes that represents yield on such notes that is in excess of 6% plus the applicable federal rate in effect for the month the Runoff Notes are issued (*i.e.,* approximately 2.77% for long-term debt issued in December 2011). The disqualified portion of the interest on the Runoff Notes may be treated for certain purposes, including the dividends received deduction for corporate holders of Runoff Notes, as a dividend to the extent of Reorganized WMI's earnings and profits (subject to certain holding period and taxable income requirements and other limitations on the dividend-received deduction). It is unclear whether the disqualified portion of the interest on the Runoff Notes would qualify as a qualifying dividend eligible for a reduced 15% rate with respect to non-corporate holders of Runoff Notes (*see* Section VIII.B.4.a, *"Dividends*," below).

The non-disqualified portion of the interest on the Runoff Notes would only be deductible by Reorganized WMI when actually paid.

f. Withholding with Respect to Second Lien Runoff Notes

Because of the uncertainty regarding the proper characterization of the Second Lien Runoff Notes, the Debtors expect that Reorganized WMI will generally withholding U.S. federal income tax at a rate of 30% (subject to potential reduction by treaty) on payments allocable to accrued OID made on the Second Lien Runoff Notes held by non-U.S. persons when such payments are actually made by Reorganized WMI or on a redemption of such Runoff Notes (*see* Section VIII.D, "*Information Reporting and Withholding*," below). *As indicated above, this discussion of the U.S. federal income tax consequences of the Seventh Amended Plan does not generally address the consequences to non-U.S. holders; accordingly, such holders should consult their tax advisors with respect to the U.S. federal income tax consequences of the Seventh Amended Plan, including ownership and disposition of the Second Lien Runoff Notes.*

4. Ownership and Disposition of Reorganized Common Stock

a. Dividends

Any distributions made on the Reorganized Common Stock will constitute dividends for U.S. federal income tax purposes to the extent of Reorganized WMI's current or accumulated earnings and profits as determined under U.S. federal income tax principles.

To the extent that a holder receives distributions in excess of Reorganized WMI's current and accumulated earnings and profits, such distributions will be treated first as a non-taxable return of capital reducing the holder's basis in its stock. Any such distributions in excess of the holder's basis in its stock (determined on a share-by-share basis) generally will be treated as capital gain. Subject to certain exceptions, dividends received by non-corporate holders prior to 2013 will be taxed under current law at a maximum rate of 15%, *provided* that certain holding period requirements and other requirements are met. Under current law, any such dividend received after 2012 will be taxed at the rate applicable to ordinary income. Dividends paid to holders that are corporations generally will be eligible for the dividend-received deduction so long as Reorganized WMI has sufficient earnings and profits. However, the dividend-received deduction is only available if certain holding period requirements are satisfied. The length of time that a shareholder has held its stock is reduced for any period during which the shareholder's risk of loss with respect to the stock is diminished by reason of the existence of certain options, contracts to sell, short sales or similar transactions. In addition, to the extent that a corporation incurs indebtedness that is directly attributable to an investment in the stock on which the dividend is paid, all or a portion of the dividend-received deduction may be disallowed.

The benefit of the dividend-received deduction to a corporate shareholder may be effectively reduced or eliminated by operation of the "extraordinary dividend" provisions of Section 1059 of the IRC, which may require the corporate recipient to reduce its adjusted tax basis in its stock by the amount excluded from income as a result of the dividend-received deduction. The excess of the excluded amount over adjusted tax basis may be treated as gain. A dividend may be treated as "extraordinary" if (1) it equals or exceeds 10% of the holder's adjusted tax basis in the stock (reduced for this purpose by the non-taxed portion of any prior extraordinary dividend), treating all dividends having ex-dividend dates within an 85-day period as one dividend, or (2) it exceeds 20% of the holder's adjusted tax basis in the stock, treating all dividends having ex-dividend dates within a 365-day period as one dividend.

b. Disposition of Reorganized Common Stock

Any gain recognized by a holder upon a subsequent taxable disposition of any Reorganized Common Stock received in respect of a Claim against the Debtors (or any stock or property received for such stock in a later tax-free exchange) would be treated as ordinary income for U.S. federal income tax purposes to the extent of (i) any bad debt deductions (or additions to a bad debt reserve) claimed with respect to the Claim for which stock was received and any ordinary loss deducted upon satisfaction of the Claim, less any income (other than interest income) recognized by the holder upon satisfaction of the Claim, and (ii) with respect to a cash-basis holder, also any amounts which would have been included in its gross income if the holder's Claim had been satisfied in full but which was not included by reason of the cash method of accounting.

In addition, as discussed above (*see* Sections VIII.B.2.d, *"Character of Gain or Loss*"), in the case of an exchange of Claims that qualifies as a recapitalization for U.S. federal income tax purposes, a portion of any gain recognized upon a subsequent disposition of any Reorganized Common Stock received may be treated as ordinary income to the extent of any carryover of accrued market discount not previously included in income.

C. Tax Treatment of Liquidating Trust and Holders of Beneficial Interests

1. Classification of the Liquidating Trust

The Liquidating Trust is intended to qualify as a "liquidating trust" for U.S. federal income tax purposes. In general, a liquidating trust is not a separate taxable entity, but rather is treated for U.S. federal income tax purposes as a "grantor trust" (*i.e.*, a pass-through type entity). However, merely establishing a trust as a liquidating trust does not ensure that it will be treated as a grantor trust for U.S. federal income tax purposes. The IRS, in Revenue Procedure 94-45, 1994-2 C.B. 684, set forth the general criteria for obtaining an IRS ruling as to the grantor trust status of a liquidating trust under a chapter 11 plan. The Liquidating Trust has been structured with the intention of complying with such general criteria. Pursuant to the Seventh Amended Plan, and in conformity with Revenue Procedure 94-45, all parties (including, without limitation, the Debtors, the Liquidating Trustee, and the Liquidating Trust Beneficiaries) are required to treat, for U.S. federal income tax purposes, the Liquidating Trust as a grantor trust of which the Liquidating Trust Beneficiaries are the owners and grantors (this treatment differs from the treatment of the Claims Reserves, discussed below). The following discussion assumes that the Liquidating Trust will be so respected for U.S. federal income tax purposes. However, no ruling has been requested from the IRS and no opinion of counsel has been requested concerning the tax status of the Liquidating Trust as a grantor trust. Accordingly, there can be no assurance that the IRS would not take a contrary position. If the IRS were to challenge successfully the classification of the Liquidating Trust, the U.S. federal income tax consequences to the Liquidating Trust, the Liquidating Trust Beneficiaries and the Debtors could vary from those discussed herein (including the potential for an entity-level tax on income of the Liquidating Trust).

2. General Tax Reporting by the Liquidating Trust and its Beneficiaries

For all U.S. federal income tax purposes, all parties (including, without limitation, the Debtors, the Liquidating Trustee, and the Liquidating Trust Beneficiaries) must treat the transfer of the Liquidating Trust Assets to the Liquidating Trust in accordance with the terms of the Seventh Amended Plan. Pursuant to the Seventh Amended Plan, the Liquidating Trust Assets (other than any assets allocated to the Liquidating Trust Claims Reserve, discussed below, and the Debtors' economic interest in the litigation proceeds retained by Reorganized WMI as a result of the election by certain Claimants to receive Reorganized Common Stock) are treated, for U.S. federal income tax purposes, as having been transferred, subject to any obligations relating to those assets, directly to the holders of the respective Claims or Equity Interests in satisfaction of their Claims or cancellation of their Equity Interests (with each holder receiving an undivided interest in such assets in accord with their economic interests in such assets), followed by the transfer by the holders to the Liquidating Trust of such assets in exchange for Liquidating Trust Interests. Accordingly, all parties must treat the Liquidating Trust as a grantor trust of which the holders of the Liquidating Trust Interests are the owners and grantors, and treat the Liquidating Trust Beneficiaries as the direct owners of an undivided interest in the Liquidating Trust Assets (other than any assets allocated to the Liquidating Trust Claims Reserve), consistent with their economic interests therein, for all U.S. federal income tax purposes.

Pursuant to the Seventh Amended Plan, on or before the Effective Date, the Debtors shall provide the Liquidating Trustee with a good-faith valuation of the Tax Refunds as of the Effective Date, or shall otherwise arrange for a valuation of such assets to be provided to the Liquidating Trustee as soon as practicable after the Effective Date by such third party professionals as the Debtors deem appropriate. Other than with respect to the Tax Refunds, the Liquidating Trustee, in consultation with the Liquidating Trust Advisory Board, will in good faith value the Liquidating Trust Assets. The Liquidating Trustee shall make the respective values available from time to time, to the extent relevant, and such values shall be used consistently by all parties to the Liquidating Trust (including, without limitation, the Debtors, the

Liquidating Trustee, and Liquidating Trust Beneficiaries) for all United States federal income tax purposes.

Allocations of taxable income of the Liquidating Trust (other than income allocable to the Liquidating Trust Claims Reserve, discussed below) among the Liquidating Trust Beneficiaries shall be determined by reference to the manner in which an amount of cash equal to such income would be distributed (were such cash permitted to be distributed at such time) if, immediately prior to such deemed distribution, the Liquidating Trust had distributed all its assets (valued at their tax book value, and other than assets allocable to the Liquidating Trust Claims Reserve) to the Liquidating Trust Beneficiaries, adjusted for prior income and loss and taking into account all prior and concurrent distributions from such Trust. Similarly, taxable loss of the Liquidating Trust shall be allocated by reference to the manner in which an economic loss would be borne immediately after a liquidating distribution of the remaining assets of the Liquidating Trust. The tax book value of the assets of the Liquidating Trust for this purpose shall equal their fair market value on the Effective Date, adjusted in accordance with tax accounting principles prescribed by the IRC, the applicable Treasury regulations, and other applicable administrative and judicial authorities and pronouncements. The effect of the above described allocation is to allocate taxable income or loss (*i.e.,* the tax impact of receipts and expenditures) in a partnership-type fashion, due to the varying tiers of beneficiaries in the Liquidating Trust.

Taxable income or loss allocated to each Liquidating Trust Beneficiary will be treated as income or loss with respect to such Liquidating Trust Beneficiary's undivided interest in the Liquidating Trust Assets, and *not* as income or loss with respect to its prior Allowed Claim or Equity Interest. The character of any income and the character and ability to use any loss will depend on the particular situation of such Liquidating Trust Beneficiary. In particular, the Debtors expect that any recovery on a Tax Refund in excess of the fair market value accorded to such refund as of the Effective Date will be ordinary income to a Liquidating Trust Beneficiary. The Debtors have obtained a private letter ruling from the IRS with respect to the characterization to the Liquidating Trust Beneficiaries of stated interest accruing with respect to Tax Refunds as "interest" income for federal income tax purposes.

The U.S. federal income tax obligations of a holder with respect to its Liquidating Trust Interest are not dependent on the Liquidating Trust distributing any cash or other proceeds. Thus, a holder may incur a U.S. federal income tax liability with respect to its allocable share of Liquidating Trust income even if the Liquidating Trust does not make a concurrent distribution to the holder. In general, other than in respect of cash retained on account of Disputed Claims and distributions resulting from undeliverable distributions (the subsequent distribution of which still relates to a holder's Allowed Claim), a distribution of cash by the Liquidating Trust will not be separately taxable to a Liquidating Trust Beneficiary since such beneficiary is already regarded for federal income tax purposes as owning the underlying assets (and was taxed at the time the cash was earned or received by such Trust). Holders are urged to consult their tax advisors regarding the appropriate federal income tax treatment of any subsequent distributions of cash originally retained by the Liquidating Trust on account of Disputed Claims.

Each of the Trustees will comply with all applicable governmental withholding requirements (*see* Sections 28.14(c), 29.13(c) and 33.7 of the Seventh Amended Plan). Thus, in the case of any Liquidating Trust Beneficiaries that are *not* U.S. persons, the Liquidating Trustee may be required to withhold up to 30% of the income or proceeds allocable to such persons, depending on the circumstances (including whether the type of income is subject to a lower treaty rate). Significantly, as discussed above, a Liquidating Trust Beneficiary is treated for federal income tax purposes as holding an undivided interest in the underlying assets of the Liquidating Trust. Accordingly, any amounts received by either of the Liquidating Trust, the economic benefit of which inures to a Liquidating Trust Beneficiary on the basis described above with respect to the allocation of income, is treated as received by

the beneficiary in respect of the underlying asset, and *not* in respect of its Allowed Claim. Thus, for example, the stated interest component of a Tax Refund claim and potentially recoveries on certain other Liquidating Trust Assets may be subject to 30% income tax withholding with respect to a Liquidating Trust Beneficiary that is *not* a U.S. person. By contrast, the Debtors have obtained a private letter ruling with respect to ordinary income that represents a "gain" relative to the fair market value of a Tax Refund claim when transferred to the Liquidating Trust, concluding that such gain and any distribution by the Liquidating Trust of cash related to such gain is not subject to 30% income tax withholding with respect to a Liquidating Trust Beneficiary that is *not* a U.S. person. *As indicated above, the foregoing discussion of the U.S. federal income tax consequences of the Seventh Amended Plan does not generally address the consequences to non-U.S. holders; accordingly, such holders should consult their tax advisors with respect to the U.S. federal income tax consequences of the Seventh Amended Plan, including owning an interest in the Liquidating Trust.*

The Liquidating Trust Interests will not be transferable, other than in certain limited circumstances.

The Liquidating Trustee will file with the IRS returns for the Liquidating Trust as a grantor trust pursuant to Treasury Regulation section 1.671-4(a). Except as discussed below with respect to the Liquidating Trust Claims Reserve, the Liquidating Trustee will annually send to the holders of record of Liquidating Trust Interests a separate statement regarding the receipts and expenditures of the Liquidating Trust as relevant for U.S. federal income tax purposes and will instruct all such holders to use such information in preparing their U.S. federal income tax returns or to forward the appropriate information to such holder's underlying beneficial holders with instructions to utilize such information in preparing their U.S. federal income tax returns.

3. Tax Reporting for Assets Allocable to Disputed Claims and Distributions from the Liquidating Trust Claims Reserve

Subject to definitive guidance from the IRS or a court of competent jurisdiction to the contrary (including the receipt by either of the Liquidating Trustee of an IRS private letter ruling if the Liquidating Trustee so requests one, or the receipt of an adverse determination by the IRS upon audit if not contested by the Liquidating Trustee), the Liquidating Trustee will (A) elect to treat any assets allocable to, or retained on account of, Disputed Claims (*i.e.,* the Liquidating Trust Claims Reserve) as a "disputed ownership fund" governed by Treasury Regulation section 1.468B-9, and (B) to the extent permitted by applicable law, report consistently with the foregoing for state and local income tax purposes. All parties (including, without limitation, the Debtors, the Liquidating Trustee and the Liquidating Trust Beneficiaries) will be required to report for tax purposes consistent with such treatment.

Accordingly, the Liquidating Trust Claims Reserve will be a separate taxable entity for U.S. federal income tax purposes, and all actual and constructive distributions from such reserve (including to the extent assets were initially allocable to Disputed Claims or Equity Interests, but are no longer) will be taxable to such reserve as if sold at fair market value. Any actual or constructive distributions from the Claims Reserves to holders of allowed claims or equity interests (including to previously Allowed Claims or Equity Interests in the event a Disputed Claim or Equity Interest is disallowed) is treated for U.S. federal income tax purposes as if received directly from the Debtors on the original Claim or Equity Interest in respect of which the Liquidating Trust Interest was issued. Thus, a holder must be careful to differentiate between the tax treatment of actual or constructive distributions from the Liquidating Trust Claims Reserve and the tax treatment of distributions out of assets of the Liquidating Trust to which the holder is already considered the direct owner for U.S. federal income tax purposes (discussed above).

The Liquidating Trustee will be responsible for payment, out of the assets of the Liquidating Trust of any Taxes imposed on the Liquidating Trust or its assets, including the Liquidating Trust Claims Reserve. To the extent any Cash retained with respect to a Disputed Claim or Equity Interest that would otherwise have been distributable upon the resolution of the Disputed Claim or Equity Interest is insufficient to pay the portion of any Taxes attributable to the income arising from the assets allocable to, or retained on account of, the Disputed Claim or Equity Interest (including any income incurred in connection with the actual or constructive distribution of such assets due to the release of such assets from the Liquidating Trust Claims Reserve upon the resolution of a Disputed Claim or Equity Interest), such Taxes may be reimbursed (as determined by the Liquidating Trustee) from the sale of any non-cash assets (including any Reorganized Common Stock) that would otherwise be actually or constructively distributed upon the resolution of the Disputed Claim or Equity Interest. For example, assume that a Disputed Claim is subsequently allowed and that the holder ordinarily would have received 10,000 shares of Reorganized Common Stock, with a value of $10,000 on the Effective Date. If the shares appreciated in value to $11,000 from the Effective Date to the date such shares are released from the Liquidating Trust Claims Reserve, a portion of the shares may be sold to pay any Taxes expected to be incurred by the Liquidating Trust Claims Reserve on the release of the shares.

D. Tax Reporting for Assets Allocable to the Disputed Equity Escrow and Distributions from the Disputed Equity Escrow

Subject to definitive guidance from the IRS or a court of competent jurisdiction to the contrary (including the receipt by the Liquidating Trustee of a private letter ruling if the Liquidating Trustee as escrow agent so requests one, or the receipt of an adverse determination by the IRS upon audit if not contested by the Liquidating Trustee), the Liquidating Trustee as escrow agent shall (A) treat the Disputed Equity Escrow as a "disputed ownership fund" governed by Treasury Regulation section 1.468B-9 (and make any appropriate elections), and (B) to the extent permitted by applicable law, report consistently with the foregoing for state and local income tax purposes. All parties (including the Liquidating Trustee, the Debtors, and the holders of Dime Warrants and Equity Interests) shall report for United States federal, state and local income tax purposes consistently with the foregoing.

Accordingly, the Disputed Equity Escrow will be a separate taxable entity for U.S. federal income tax purposes, and all distributions from such escrow will be taxable to such reserve as if sold at fair market value. Any distributions from the escrow will be treated for U.S. federal income tax purposes as if received directly by the recipient from the Debtors on the original Claim or Equity Interest of such recipient.

The Liquidating Trustee, which will serve as escrow agent for the Disputed Equity Escrow, will be responsible for payment, out of the assets of the Disputed Equity Escrow, of any Taxes imposed on the escrow or its assets. In the event, and to the extent, any Cash in the Disputed Equity Escrow is insufficient to pay the portion of any such Taxes attributable to the taxable income arising from the assets of the escrow (including any income that may arise upon the distribution of the assets in the escrow), assets of the escrow may be sold to pay such Taxes

E. Information Reporting and Withholding.

All distributions to holders of Claims and Equity Interests under the Seventh Amended Plan (including from the Liquidating Trust, the Liquidating Trust Claims Reserve, or the Disputed Equity Escrow), and amounts earned or received by the Liquidating Trust and, thus, treated as earned or received by the Liquidating Trust Beneficiaries, are subject to any applicable tax withholding, including employment tax withholding.

Under U.S. federal income tax law, interest, dividends, and other reportable payments may, under certain circumstances, be subject to "backup withholding" at the then applicable withholding rate (currently 28%). Backup withholding generally applies if the holder (a) fails to furnish its social security number or other taxpayer identification number ("TIN"), (b) furnishes an incorrect TIN, (c) fails properly to report interest or dividends, or (d) under certain circumstances, fails to provide a certified statement, signed under penalty of perjury, that the TIN provided is its correct number and that it is a United States person that is not subject to backup withholding. Backup withholding is not an additional tax but merely an advance payment, which may be refunded to the extent it results in an overpayment of tax and the appropriate information is supplied to the IRS. Certain persons are exempt from backup withholding, including, in certain circumstances, corporations and financial institutions.

In addition, as discussed above under Section VIII.C, "*Tax Treatment of the Liquidating Trust and Holders of Beneficial Interests,*" a holder of a Liquidating Trust Interest that is a *not* a U.S. person may be subject to 30% withholding, depending on, among other things, the particular type of income and whether the type of income is subject to a lower treaty rate. And, as mentioned above under Section VIII.B.3.f, the Debtors expect that holders of Second Lien Runoff Notes who are *not* U.S. persons may be subject to 30% withholding (subject to potential reduction by treaty) with respect to payments on the Runoff Notes (including upon a redemption) that are allocable to accrued OID. *A non-U.S. holder may also be subject to other adverse consequences in connection with the implementation of the Seventh Amended Plan. As discussed above, the foregoing discussion of the U.S. federal income tax consequences of the Seventh Amended Plan does not generally address the consequences to non-U.S. holders of Allowed Claims or Equity Interests.*

Recent Legislation. Under legislation recently enacted into law, certain payments made after December 31, 2012 to certain foreign entities (including foreign accounts or foreign intermediaries) would be subject to a 30% withholding tax unless various U.S. information reporting and due diligence requirements have been satisfied. Payments subject to such requirements include dividends on and the gross proceeds of dispositions of Reorganized Common Stock and likely include distributions by the Liquidating Trust. These requirements are different from, and in addition to, the withholding tax requirements described above under Section VIII.C.2, "*General Tax Reporting by the Liquidating Trust and its Beneficiaries.*" A holder who is not a U.S. person should consult their tax advisor concerning the application of this legislation to their particular circumstances.

The foregoing summary has been provided for informational purposes only. All holders of Claims or Equity Interests receiving a distribution under the Seventh Amended Plan are urged to consult their tax advisors concerning the federal, state, local and foreign tax consequences applicable under the Seventh Amended Plan.

IX.
CONSEQUENCES UNDER THE FEDERAL SECURITIES LAWS

A. General Application of section 1145 to New Interests

Pursuant to the Seventh Amended Plan, (i) Reorganized WMI will issue the Runoff Notes and Reorganized Common Stock (collectively, the "Reorganized WMI Interests") to certain holders of Allowed Claims and Equity Interests, and (ii) the Liquidating Trust will issue Liquidating Trust Interests to certain Holders of Allowed Claims and Equity Interests. To the maximum extent provided by section 1145 of the Bankruptcy Code and applicable non-bankruptcy laws, rules and regulations, the offer and sale under the Seventh Amended Plan of the Reorganized WMI Interests and the Liquidating Trust Interests (collectively, the "New Interests") will be exempt from registration under the Securities Act, all rules and regulations promulgated thereunder, and all applicable state and local securities laws and

regulations. The application of section 1145 and other applicable federal securities laws is discussed in more detail below with respect to each of the Reorganized WMI Interests and the Liquidating Trust Interests.

B. Reorganized WMI Interests

1. Transfer Restrictions Under the Securities Laws

Section 1145 of the Bankruptcy Code generally exempts from registration under the Securities Act the offer or sale, under a chapter 11 plan of reorganization, of a security of a debtor, of an affiliate participating in a joint plan with the debtor, or of a successor to a debtor under a plan, if such securities are offered or sold in exchange for a claim against, or equity interest in, such debtor or affiliate or principally in such exchange and partly for cash. The offer and sale of Reorganized WMI Interests by Reorganized WMI pursuant to the Seventh Amended Plan to certain holders of Claims against, or Equity Interests in (as applicable) the Debtors, will be based on the exemption provided by section 1145 from the registration requirements of the Securities Act, all rules and regulations promulgated thereunder, and all applicable state and local securities laws and regulations. Because these securities will not be deemed "restricted" (as that term is defined in Rule 144(a)(3) under the Securities Act), the Reorganized WMI Interests may be resold without registration under the Securities Act pursuant to the exemption provided by Section 4(1) of the Securities Act, unless the holder is an "underwriter," as that term is defined in section 1145(b) of the Bankruptcy Code, with respect to the Reorganized WMI Interests. In addition, the Reorganized WMI Interests generally may be resold without registration under state securities laws pursuant to various exemptions provided by the respective laws of the several states. However, recipients of the Reorganized WMI Interests issued under the Seventh Amended Plan are advised to consult with their own legal advisors as to the availability of any such exemption from registration under state law in any given instance and as to any applicable requirements or conditions to such availability.

Section 1145(b) of the Bankruptcy Code defines "underwriter" for purposes of the Securities Act as one who (a) purchases a claim with a view to distribution of any security to be received in exchange for the claim other than in ordinary trading transactions, (b) offers to sell securities issued under a plan for the holders of such securities, (c) offers to buy securities issued under a plan from Persons receiving such securities, if the offer to buy is made with a view to distribution, or (d) is a control Person of the issuer of the securities, within the meaning of Section 2(a)(11) of the Securities Act. For purposes of the Securities Act, the term "control," which includes the terms "controlling," "controlled by," and "under common control with," is defined by Rule 405 under the Securities Act as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise."

For Persons deemed to be "underwriters" who receive the Reorganized WMI Interests pursuant to the Seventh Amended Plan, including control Person underwriters (collectively, the "Restricted Holders"), resales of the Reorganized WMI Interests will not be exempt under section 1145 of the Bankruptcy Code from registration under the Securities Act. Restricted Holders may, however, be able, and under certain conditions described below, to sell their Reorganized WMI Interests without registration pursuant to the safe harbor resale provisions of Rule 144 under the Securities Act, or any other applicable exemption under the Securities Act.

Generally, Rule 144 provides that Persons selling securities received in a transaction not involving a public offering or who are "affiliates" of an issuer will not be deemed to be underwriters if certain conditions are met. For purposes of the Securities Act, the term "affiliate" is defined by Rule 405 under the Securities Act to mean "a person that directly, or indirectly through one or more intermediaries, controls or is controlled by, or under common control with," the issuer. These conditions vary depending

on whether the seller is a holder of restricted securities or a control Person of the issuer and whether the security to be sold is an equity security or a debt security. Depending on the relevant facts and circumstances, the conditions include required holding periods, the requirement that current public information with respect to the issuer be available, a limitation as to the amount of securities that may be sold within a three-month period, the requirement that the securities be sold in a "brokers transaction" or in a transaction effected directly with a "market maker" and that notice of the resale be filed with the SEC. The Debtors cannot assure, however, that adequate current public information will exist with respect to Reorganized WMI at all times and, therefore, that the safe harbor provisions of Rule 144 under the Securities Act will ever be available to exempt resales. Pursuant to the Seventh Amended Plan, certificates evidencing any Reorganized WMI Interests received by Restricted Holders will bear a legend substantially in the form below:

"THE SECURITIES REPRESENTED BY THIS CERTIFICATE HAVE NOT BEEN REGISTERED UNDER THE SECURITIES ACT, OR THE SECURITIES LAWS OF ANY STATE AND MAY NOT BE SOLD OR TRANSFERRED IN THE ABSENCE OF AN EFFECTIVE REGISTRATION STATEMENT UNDER THE ACT AND SAID LAWS OR AN EXEMPTION FROM THE REGISTRATION REQUIREMENTS THEREOF."

* * * * *

IN VIEW OF THE COMPLEX, SUBJECTIVE NATURE OF THE QUESTION OF WHETHER A RECIPIENT OF REORGANIZED WMI INTERESTS MAY BE AN UNDERWRITER OR AN AFFILIATE OF REORGANIZED WMI, THE DEBTORS MAKE NO REPRESENTATIONS CONCERNING THE RIGHT OF ANY PERSON TO TRADE IN NEW SECURITIES TO BE DISTRIBUTED PURSUANT TO THE SEVENTH AMENDED PLAN. ACCORDINGLY, THE DEBTORS RECOMMEND THAT POTENTIAL RECIPIENTS OF REORGANIZED WMI INTERESTS CONSULT THEIR OWN COUNSEL CONCERNING WHETHER THEY MAY FREELY TRADE SUCH REORGANIZED WMI INTERESTS.

2. Listing and SEC Reporting

As of the Effective Date, the Reorganized WMI Interests will not be listed for trading on any national securities exchange or other organized trading market. Consequently, the liquidity of the Reorganized WMI Interests will be limited as of the Effective Date. The future liquidity of any trading markets for the Reorganized WMI Interests will depend, among other things, upon the number of holders of the Reorganized WMI Interests, whether the Reorganized WMI Interests are listed for trading on a national securities exchange, or other organized trading market at some future time, and whether Reorganized WMI begins to file reports with the SEC pursuant to the Exchange Act. In this regard, Reorganized WMI is deemed to be a successor to WMI for the purposes of the Exchange Act and will continue to be subject to the reporting requirements of the Exchange Act until Reorganized WMI has less than 300 holders of record of Reorganized Common Stock and files a Form 15 with the SEC to suspend its reporting obligations under the Exchange Act. Periodic SEC reporting is a requirement for listing the Reorganized WMI Interests on a national securities exchange.

3. Transfer Restrictions under the New Certificate of Incorporation of Reorganized WMI with respect to the Reorganized Common Stock

From and after the Effective Date, the certificate of incorporation of Reorganized WMI will contain certain transfer restrictions as further described below in relation to the transfer of Reorganized Common Stock. In particular, without the approval of Reorganized WMI's board of directors, (i) no Person will be permitted to acquire, whether directly or indirectly, and whether in one

transaction or a series of related transactions, Reorganized Common Stock, to the extent that after giving effect to such purported acquisition (a) the purported acquirer or any other Person by reason of the purported acquirer's acquisition would become a Substantial Holder (as defined below) of any class of stock of Reorganized WMI, or (b) the percentage of stock ownership of a person that, prior to giving effect to the purported acquisition, is already a Substantial Holder of the class of stock sought to be acquired would be increased; and (ii) no Substantial Holder may dispose, directly or indirectly, of any shares of Reorganized WMI stock without the consent of a majority of Reorganized WMI's board of directors. A "Substantial Holder" is a person that owns (as determined for NOL purposes) 4.75% of any class of stock of Reorganized WMI, including any instrument treated as stock for NOL purposes.

4. Transfer Restrictions under the Indenture for the Second Lien Runoff Notes

The indenture for the Second Lien Runoff Notes may include certain restrictions on accumulation of 4.75% or more of the aggregate principal amount of such notes if such restrictions would not preclude the listing of such notes with DTC.

C. Liquidating Trust Interests

1. Transfer Restrictions Under the Securities Laws

As noted under Section IX.B.1, Section 1145 of the Bankruptcy Code generally exempts from registration under the Securities Act the offer or sale, under a chapter 11 plan of reorganization, of a security of a debtor, of an affiliate participating in a joint plan with the debtor, or of a successor to a debtor under a plan, if such securities are offered or sold in exchange for a claim against, or equity interest in, such debtor or affiliate or principally in such exchange and partly for cash. Because the Liquidating Trust is a successor of the Debtors for purposes of section 1145 of the Bankruptcy Code and will be relying on the exemption from Securities Act registration provided by section 1145, the Liquidating Trust Interests (to the extent that they are deemed to constitute "securities" within the meaning of the Securities Act) that will be offered and sold by the Liquidating Trust under the Seventh Amended Plan to certain holders of Claims against, or Equity Interests in (as applicable), the Debtors will be exempt from registration under the registration requirements of the Securities Act, all rules and regulations promulgated thereunder, and all applicable state and local securities laws and regulations. Pursuant to the terms of the Liquidating Trust Agreement, however, a Liquidating Trust Interest is not transferable or assignable by a Liquidating Trust Beneficiary except by will, intestate succession or operation of law.

2. Listing and SEC Reporting

As noted above, the Liquidating Trust Interests are not transferable or assignable except by will, intestate succession or operation of law. The Liquidating Trust Interests will not be listed for trading on any national securities exchange or other organized trading market and the Liquidating Trustee does not intend to take any action to encourage or otherwise promote the development of an active trading market. It is possible that the Liquidating Trust will make certain filings with the SEC on a voluntary basis, but there is no assurance that the Liquidating Trust will do so or continue to do so.

TAXES AND TRANSFERS AND TRUSTS*

*Alec P. Ostrow***

Introduction

Taxes are never too far away from the contemplation of anyone structuring a transaction or a business enterprise. It is thus inevitable that tax aspects of such structures will get litigated in the context of bankruptcy or creditors' rights. In the last year courts have issued significant decisions on issues in the intersection of tax and fraudulent transfer law: transferee liability for unpaid corporate taxes, the ability to recover from the government payments by an insolvent corporation of taxes owed by the corporation's principal. At the junction of tax, trust and bankruptcy law, courts have grappled with the rights of affiliated corporations that file consolidated tax returns and are parties to tax sharing agreements in tax refunds, when the parent companies are debtors in bankruptcy cases. Although these issues nominally arise under the Internal Revenue Code[1] or concern the Internal Revenue Service ("IRS"), the rule of decision is premised in each instance upon state law. This article will explore the intersection of federal taxes, fraudulent transfers, and express trusts.

Taxes and Fraudulent Transfers

Fraudulent Transferee Liability for Corporate Taxes

Sometimes the IRS needs to invoke the fraudulent transfer laws to collect taxes. Two court of appeals cases decided last

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*The author has decided not to add to the title the interjection that readily springs to mind and comes from the 1939 classic movie, "The Wizard of Oz," anticipating that thoughtful readers will supply it to themselves.

**Alec P. Ostrow is a partner in Becker, Glynn, Muffly, Chassin & Hosinski LLP, New York, New York, and specializes in bankruptcy and corporate reorganization. He is also an adjunct professor of law in the LL.M. in Bankruptcy Program at St. John's University School of Law, and a fellow of the American College of Bankruptcy. He can be reached at (212) 303-9577 and aostrow@beckerglynn.com.

[1]26 U.S.C.A. §§ 1 to 9834.

year,[2] and one decided the previous year,[3] involved variations of a tax savings pattern known to tax professionals as a "midco" or "intermediary" transaction,[4] which is used in the sale of a business or assets of a C corporation[5] whose assets have substantially appreciated in value after their acquisition. A sale of these assets by the C corporation would trigger taxable income to the corporation,[6] and a distribution to the shareholders of the sale proceeds would trigger taxable income to them as well.[7] Consequently, the sellers in this instance would ordinarily prefer to sell the stock of the C corporation. The buyers, on the other hand, would ordinar-

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[2]*Diebold Foundation, Inc. v. C.I.R.*, 736 F.3d 172, 2013-2 U.S. Tax Cas. (CCH) P 50590, 112 A.F.T.R.2d 2013-6901 (2d Cir. 2013); *Frank Sawyer Trust of May 1992 v. C.I.R.*, 712 F.3d 597, 600, 2013-1 U.S. Tax Cas. (CCH) P 50253, 111 A.F.T.R.2d 2013-1434 (1st Cir. 2013).

[3]*Starnes v. C.I.R.*, 680 F.3d 417, 419–20, 2012-1 U.S. Tax Cas. (CCH) P 50380, 109 A.F.T.R.2d 2012-2326 (4th Cir. 2012).

[4]The Second Circuit's decision uses the term "Midco transactions" interchangeably with "intermediary transactions" to describe the kind of technique in its fact pattern, and calls the intermediary a "Midco." Diebold, 736 F.3d at 175. *See also Enbridge Energy Co., Inc. v. U.S.*, 553 F. Supp. 2d 716, 719, 2008-1 U.S. Tax Cas. (CCH) P 50266, 171 O.G.R. 537, 101 A.F.T.R.2d 2008-1733 (S.D. Tex. 2008), judgment aff'd, 354 Fed. Appx. 15, 2009-2 U.S. Tax Cas. (CCH) P 50737, 171 O.G.R. 529, 104 A.F.T.R.2d 2009-7289 (5th Cir. 2009) (also describing a " Midco transaction"); Farey-Jones v. Buckingham, No. 99 CV 4205 (ADS) (E.D.N.Y. July 7, 2004) (Google Scholar) (quoting testimony describing a "Midco transaction"). *See generally,* Calvin H. Johnson, *Profits from Tax Evasion Under the Midco Transaction*, 139 Tax Notes 1485 (Mar. 25, 2013). The technique in *Diebold* differs from a variant used by a company actually called "MidCoast Credit Corp." or simply, "MidCoast," whose transactions are described by the First and Fourth Circuits' decisions. Frank Sawyer Trust, 712 F.3d at 600; Starnes, 680 F.3d at 419–20. "MidCoast" is also mentioned in several tax court decisions. *E.g.*, *Slone v. Comm'r*, T.C. Memo 2012-57 at *7 (T.C. 2012); *Feldman v. Comm'r*, T.C. Memo 2011-297, at *7 (T.C. 2011).

[5]A C corporation is any corporation that is not an S corporation. 26 U.S.C.A. § 1361(a)(2). A C corporation is taxed under the statutory scheme set forth in subchapter C of chapter 1 of subtitle A of the Internal Revenue Code. 26 U.S.C.A. §§ 301 to 385. An S corporation is an eligible small business corporation that elects to be treated as such. 26 U.S.C.A. §§ 1361(a)(1), 1361(b), 1362(a). An S corporation is generally not subject to the taxes imposed on C corporations. 26 U.S.C.A. § 1363(a). Rather, it is essentially a tax-reporting entity that passes taxable income or loss through to its shareholders. 26 U.S.C.A. §§ 1366(a), 6037(a).

[6]*See* 26 U.S.C.A. §§ 61(a)(3) (including in gross income gains derived from dealings in property), 301 (including in the gross income of corporations distributions in respect of stock), 1001 (determining gain or loss on sale of property).

[7]*See* 26 U.S.C.A. §§ 61(a)(7) (including in gross income dividends), 331 (dealing with gain or loss to shareholders in corporate liquidations).

ily prefer to purchase the assets of the C corporation. In this way, the buyers avoid buying the liabilities of the C corporation along with its assets, require the sellers to absorb the tax liability associated with the sale of the assets, and acquire a basis in the assets for tax purposes equal to the purchase price.[8] A "midco" or "intermediary" transaction is designed to provide the sellers an ultimate recovery that resembles the tax benefits of a stock sale, while the buyers receive the tax benefits of an asset sale.[9] The intermediary itself absorbs a tax obligation. If the intermediary does not satisfy this obligation, or if there is an unsuccessful scheme involving the intermediary to offset the obligation with other losses, and neither the intermediary nor the C corporation has assets available to pay the resulting tax liability, the IRS seeks recovery from the selling shareholders and their transferees.

This situation is exemplified in the Second Circuit's decision last year.[10] The C corporation, a personal holding company, owned substantial assets, the direct sale of which would have triggered a substantial tax liability.[11] The shareholders, a family trust and a family foundation, sought professional advice on how to minimize taxes and maximize the net distribution to shareholders. The resulting arrangement had a newly formed "midco" purchase the stock of the C corporation at approximately 97% of the market value of the assets, whereas, had the C corporation sold the assets directly, the shareholders would have realized approximately 74.5% of the market value of the assets.[12] The "midco" then separately sold off the assets of the C corporation at

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[8] *See* 26 U.S.C.A. § 1012(a) (stating the general rule that the basis of property is its cost). Under certain circumstances, a corporation that purchases the stock of another corporation can elect a tax treatment of the transaction as an asset sale. *See* 26 U.S.C.A. § 338. In such a situation, the purchasing corporation gets a new basis in the acquired assets, but the corporate income tax that is deemed incurred by the acquired or target corporation must nevertheless be paid. *See* Enbridge Energy, 553 F. Supp. 2d at 726.

[9] *See* Enbridge Energy, 553 F. Supp. 2d at 719.

[10] Diebold, 736 F.2d at 175–76.

[11] The tax liability on the built-in gain was stated to be approximately $81 million. Diebold, 736 F.3d at 176. The Second Circuit's opinion does not mention any debt owed by the C corporation. Neither does the opinion of the tax court. *Diebold v. C.I.R.*, T.C. Memo. 2010-238, T.C.M. (RIA) P 2010-238, 100 T.C.M. (CCH) 370 (2010), vacated sub nom. Diebold Found., Inc. v. Comm' r, 736 F.3d 172 (2d Cir. 2013).

[12] Diebold, 736 F.3d at 178, 180. The assets were valued at $319 million. The stock purchase price was $309 million. The parties agreed that the purchase price would be the value of the assets less 4.5% of the built-in gain. In contrast,

approximately their market value.[13] All the parties filed tax returns. Significantly, the C corporation filed a consolidated income tax return[14] with its new parent, the "midco." This return reported the asset sales, but claimed losses, attributable to the "midco," sufficient to offset the gains, and resulted in no net tax liability.[15] The losses, however, were determined to be artificial. The IRS recharacterized the transactions as an asset sale by the C corporation, followed by a liquidating distribution to the C corporation's shareholders, and assessed a deficiency against the C corporation.[16] The C corporation did not contest this recharacterization and deficiency, but lacked any assets to pay the tax obligation. The IRS then sought to collect from alleged transferees.[17]

The transferee liability statute in the Internal Revenue Code[18] has long been held to be essentially procedural rather than substantive.[19] Although the Internal Revenue Code determines who is a transferee,[20] non-tax law determines whether the

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an asset sale at the corporate tax rate then in effect would have yielded the value of the assets less 35% of the built-in gain. Diebold, 736 F.3d at 178 & n.4. One of the selling shareholders, the family trust, dissolved and made distributions to separate trusts headed by family members. Diebold, 736 F.3d at 181.

[13]Diebold, 736 F.3d at 179–81. One of the assets of the C corporation was a farm, which the family of the selling shareholders was interested in retaining. An option to purchase the farm by an entity owned by the family was part of the stock purchase transaction. The option was exercised shortly after the stock purchase transaction closed, so that the full purchase price for the farm was received by the C corporation. Diebold, 736 F.3d at 179–81.

[14]26 U.S.C.A. § 1501.

[15]Diebold, 736 F.3d at 181.

[16]Diebold, 736 F.3d at 181. The deficiency, including interest and penalties, amounted to approximately $100 million.

[17]Diebold, 736 F.3d at 181.

[18]26 U.S.C.A. § 6901. In general, this statute provides that the relevant tax liability shall "be assessed, paid, and collected in the same manner and subject to the same provisions and limitations as in the case of the taxes with respect to which the liabilities were incurred." 26 U.S.C.A. § 6901(a). Specifically, with respect to income taxes, the transferee has the "liability at law or in equity, of a transferee of property of the taxpayer." 26 U.S.C.A. § 6901(a)(1)(A)(i).

[19]*C.I.R. v. Stern*, 1958-2 C.B. 937, 357 U.S. 39, 42, 78 S. Ct. 1047, 2 L. Ed. 2d 1126, 58-2 U.S. Tax Cas. (CCH) P 9594, 1 A.F.T.R.2d 1899 (1958).

[20]26 U.S.C.A. § 6901(h) defines "transferee" to include a "done, heir, legatee, devisee, and distribute." The Treasury Regulations, issued under the statutory authority of the Secretary of the Treasury to prescribe rules and regulations for the enforcement of the Internal Revenue Code, *see* 26 U.S.C.A.

transferee is liable.[21] That non-tax law is often state fraudulent transfer law. In the Second Circuit's case, the New York fraudulent transfer law applied.[22]

Irrespective of whether any of the C corporation's selling shareholders or their distributees are considered "transferees" for federal tax purposes,[23] the Second Circuit reasoned that they have liability only if they can be considered "transferees" under New York's fraudulent transfer statute.[24] Because the selling shareholders were not the recipients of the assets of the taxpayer, the C corporation,[25] the only theory on which they could be held liable is one where the related transactions are collapsed.[26] For example, in what the court described as a "paradigmatic scheme," "one transferee gives fair value to the debtor in exchange for the debtor's property," which the debtor transfers to a second transferee for no consideration, leaving the debtor with no property and no consideration.[27] To collapse transactions under New York law, two elements are required: The consideration from the

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§ 7805(a), additionally include "the shareholder of a dissolved corporation, . . . the successor of a corporation, . . . and other classes of distributees." 26 C.F.R. § 301.6901-1(b). Since the Treasury Regulations refer to the "transferee of a transferee" in the context of determining the period of limitations, 26 C.F.R. § 301.6901-1(c)(2), it has been held that the "transferee of a transferee" is also a "transferee." Frank Sawyer Trust, 712 F.3d at 610 (citing *Berliant v. C.I.R.*, 729 F.2d 496, 497 n.2, 84-1 U.S. Tax Cas. (CCH) P 13563, 53 A.F.T.R.2d 84-1619 (7th Cir. 1984)).

[21]Diebold, 736 F.3d at 183–84; *see* Frank Sawyer Trust, 712 F.3d at 602–03; Starnes, 680 F.3d at 426. Each of these cases decided that the determinations of (1) whether an individual or entity is a transferee under federal tax law, and (2) whether the transferee is liable under non-tax law, are independent inquiries. Diebold, 736 F.3d at 184–86; Starnes, 680 F.3d at 427; *see* Frank Sawyer Trust, 712 F.3d at 605.

[22]Diebold, 736 F.3d at 184.

[23]*See, e.g., Frank Lyon Co. v. U. S.*, 1978-1 C.B. 46, 435 U.S. 561, 573, 98 S. Ct. 1291, 55 L. Ed. 2d 550, 78-1 U.S. Tax Cas. (CCH) P 9370, 41 A.F.T.R.2d 78-1142 (1978) (discussing the "doctrine of substance over form" in tax matters); *Gregory v. Helvering*, 1935-1 C.B. 193, 293 U.S. 465, 470, 55 S. Ct. 266, 79 L. Ed. 596, 35-1 U.S. Tax Cas. (CCH) P 9043, 14 A.F.T.R. (P-H) P 1191, 97 A.L.R. 1355 (1935) (rejecting an argument that would "exalt artifice above reality" for tax purposes).

[24]Diebold, 736 F.3d at 186.

[25]Diebold, 736 F.3d at 186. There is a small exception with respect to the farm. *See* Diebold, 736 F.3d at 179–81.

[26]Diebold, 736 F.3d at 186 (citing *Orr v. Kinderhill Corp.*, 991 F.2d 31, 35–36 (2d Cir. 1993)).

[27]Diebold, 736 F.3d at 186 (quoting *HBE Leasing Corp. v. Frank*, 48 F.3d 623, 635, 31 Fed. R. Serv. 3d 1422 (2d Cir. 1995).

first transferee must be "reconveyed . . . for less than fair consideration[28] or with actual intent to defraud creditors"; and the transferee from whom recovery is sought must have "actual or constructive knowledge of the entire scheme that renders [the] exchange with the debtor fraudulent."[29]

The Second Circuit held that this analysis applied to the "midco" transaction, even though it had the additional wrinkle of the "midco" through which the consideration for the purchase of the C corporation's assets passed as a conduit.[30] Therefore, the issue of the transferee liability of the selling shareholders or their distributees turned on whether the selling shareholders had the requisite actual or constructive knowledge of the entire scheme and its fraudulent character.[31] Constructive knowledge, or whether someone "should have known," is derived from the surrounding circumstances and includes "inquiry knowledge."[32] The court of appeals observed ambiguity in the case law. Some cases require "knowledge that ordinary diligence would have elicited";[33] others a "more active avoidance of the truth."[34] The Second Circuit did not need to choose between these alternatives, because it held, after an extensive review of the facts and contrary to the tax court, that the selling shareholders of the C corporation in the "midco" transaction had the requisite constructive knowledge under either test.[35] The matter was remanded to the tax court to determine whether the parties from whom the IRS sought recovery were "transferees" under the Internal Revenue Code, as well as statute of limitations issues.[36]

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[28]The New York fraudulent transfer statute, which adopted the Uniform Fraudulent Conveyances Act, uses the term "fair consideration," which includes a requirement of "good faith" in addition to a requirement of a "fair equivalent." N.Y. Debt. & Cred. Law § 272.

[29]Diebold, 736 F.3d at 186 (quoting HBE Leasing, 48 F.3d at 635).

[30]Diebold, 736 F.3d at 186–87.

[31]Diebold, 736 F.3d at 187.

[32]Diebold, 736 F.3d at 187.

[33]Diebold, 736 F.3d at 187 (quoting *U.S. v. Orozco-Prada*, 636 F. Supp. 1537, 1543 (S.D. N.Y. 1986), judgment aff'd, 847 F.2d 836 (2d Cir. 1988) (table)).

[34]Diebold, 736 F.3d at 187 (quoting HBE Leasing, 48 F.3d at 636).

[35]Diebold, 736 F.3d at 188–90.

[36]Diebold, 736 F.3d at 190.

In the First Circuit's case, which had a variation on the "midco" fact pattern,[37] the court of appeals remanded to the tax court to allow the IRS to pursue a different theory of liability against the selling shareholder.[38] The stock of the C corporations was sold to a "midco" which then caused the C corporations to "upstream" substantial cash to the "midco." This transfer rendered the C corporations insolvent. Because of unsatisfied tax liabilities, the IRS became a creditor of the C corporations, and under Massachusetts fraudulent transfer law could pursue a fraudulent transfer action against not only the "midco," but the constructive fraudulent transferees of the "midco," including the selling shareholder of the C corporations.[39] Whether the selling shareholder was, in fact, a constructive fraudulent transferee depended on whether the "midco" received reasonably equivalent value for the payment made to the selling shareholder, a question for the tax court on remand.[40]

In both 2013 court of appeals cases, the tax court had ruled against the IRS's pursuit of the selling shareholders of the C corporation in different "midco" income tax avoidance transactions, and the Commissioner appealed. Although neither court of appeals approved the theory of liability urged by the Commissioner, which sought to incorporate tax law "substance over form" notions into state fraudulent transfer law,[41] both times the courts of appeal reversed, based upon a more probing and thorough analysis of applicable state fraudulent transfer law.[42]

The IRS as a Fraudulent Transferee

Sometimes the IRS finds itself in the position of defendant in a fraudulent transfer action. If an S corporation, which ordinarily owes no income taxes, pays the income taxes for its shareholders,

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[37]Frank Sawyer Trust, 712 F.2d at 600–02.

[38]Frank Sawyer Trust, 712 F.2d at 606. The court of appeals would not disturb the tax court's finding that the selling shareholder lacked constructive knowledge of the "midco" tax avoidance scheme, which was deemed necessary to pursue a theory of collapsing transactions. Frank Sawyer Trust, 712 F.2d at 606.

[39]Frank Sawyer Trust, 712 F.2d at 607–08.

[40]Frank Sawyer Trust, 712 F.2d at 608–09.

[41]Diebold, 736 F.3d at 184–86; Frank Sawyer Trust, 712 F.3d at 605.

[42]Diebold, 736 F.3d at 186–87; Frank Sawyer Trust, 712 F.3d at 607–08.

the S corporation arguably receives no value for this payment.[43] If at the time of such payments, the S corporation was insolvent, undercapitalized, or knew it will incur debts beyond its ability to pay when such debts come due, and the S corporation ends up in bankruptcy, the payments may be challenged as constructive fraudulent transfers, both under the Bankruptcy Code[44] and under state law,[45] which may be employed by a bankruptcy trustee.[46] The Bankruptcy Code's fraudulent transfer statute has a two-year reach-back period.[47] State law statutes of limitations, which in bankruptcy cases translate into reach-back periods, may be longer. The Uniform Fraudulent Transfer Act has a four-year statute of limitations.[48] The applicable statute of limitations in New York, which continues to use the Uniform Fraudulent Conveyances Act, is six years.[49]

When a trustee employs the longer reach-back period of state law to avoid a fraudulent transfer, he or she must step into the shoes of an actual creditor holding an allowable unsecured claim capable of avoiding the transfer.[50] When the transferee is the IRS or a state taxing authority, sovereign immunity ordinarily prevents the creditor from avoiding the transfer.[51] Section 106(a)(1) of the Bankruptcy Code abrogates sovereign immunity for governmental units with respect to a list of Code provisions,[52] including the Bankruptcy Code's own fraudulent transfer provi-

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[43]A counterargument is that the payments constitute compensation to the shareholders. This counterargument may fail for shareholders who provide no services, and therefore are not entitled to compensation, or who are already excessively compensated for the services they do provide, and therefore not entitled to any additional compensation.

[44]11 U.S.C.A. § 541(a)(1)(B).

[45]*See* Uniform Fraudulent Transfer Act §§ 4(a)(2), 5(a); Uniform Fraudulent Conveyances Act §§ 4 to 6.

[46]11 U.S.C.A. § 544(a) to (b).

[47]11 U.S.C.A. § 548(a)(1).

[48]Uniform Fraudulent Transfer Act § 9(b).

[49]N.Y.C.P.L.R. 213(1),(8) (actions for which no other limitations period is specified and actions for fraud).

[50]11 U.S.C.A. § 544(b)(1).

[51]*F.D.I.C. v. Meyer*, 510 U.S. 471, 475, 114 S. Ct. 996, 127 L. Ed. 2d 308, 63 Empl. Prac. Dec. (CCH) P 42847 (1994); *see U.S. v. Nordic Village Inc.*, 503 U.S. 30, 33–34, 112 S. Ct. 1011, 117 L. Ed. 2d 181, 22 Bankr. Ct. Dec. (CRR) 1022, 26 Collier Bankr. Cas. 2d (MB) 9, Bankr. L. Rep. (CCH) P 74435B, 92-1 U.S. Tax Cas. (CCH) P 50109, 69 A.F.T.R.2d 92-687 (1992) (construing prior version of Bankruptcy Code's provision waiving sovereign immunity).

[52]11 U.S.C.A. § 106(a)(1).

sion, section 548,[53] and the one that allows a trustee to employ state law, section 544.[54] The issue addressed earlier this year by the Seventh Circuit,[55] is whether this abrogation removes not only the IRS's sovereign immunity to the trustee's section 544 lawsuit, but also removes the sovereign immunity bar to the actual creditor's lawsuit, which is a predicate for the trustee's substantive recovery. A number of lower courts have held that the abrogation of sovereign immunity in section 106 also applies to the actual creditor's predicate action, because otherwise the abrogation of sovereign immunity with respect to the trustee's section 544 lawsuit would be rendered meaningless.[56]

In the Seventh Circuit's case, the S corporation made nine payments of its principal's income tax liability, eight within the two-year reach-back period of the Bankruptcy Code's fraudulent transfer statute, and one outside that period, but within the four-year reach-back period of the Illinois version of the Uniform Fraudulent Transfer Act.[57] The trustee sought to recover all nine payments. The parties reached a settlement for the eight payments within the two-year reach-back period, and contested the

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[53]11 U.S.C.A. § 548.

[54]11 U.S.C.A. § 544.

[55]*In re Equipment Acquisition Resources, Inc.*, 742 F.3d 743, 59 Bankr. Ct. Dec. (CRR) 22, 71 Collier Bankr. Cas. 2d (MB) 194, Bankr. L. Rep. (CCH) P 82582, 113 A.F.T.R.2d 2014-796 (7th Cir. 2014).

[56]*See In re Valley Mortgage, Inc.*, 112 A.F.T.R.2d 2013-6445, 2013 WL 5314369, *4 (Bankr. D. Colo. 2013); *In re DBSI, Inc.*, 463 B.R. 709, 716–17, 56 Bankr. Ct. Dec. (CRR) 16 (Bankr. D. Del. 2012) (state officials); *In re Custom Contractors, LLC*, 439 B.R. 544, 548, 107 A.F.T.R.2d 2011-449 (Bankr. S.D. Fla. 2010), rev' d in part on other grounds, 484 B.R. 835 (S.D. Fla. 2012), aff' d, 2014 WL 1226852 (11th Cir. Mar. 26, 2014); *In re C.F. Foods, L.P.*, 265 B.R. 71, 85–86, 38 Bankr. Ct. Dec. (CRR) 55, 2001-2 U.S. Tax Cas. (CCH) P 50599, 88 A.F.T.R.2d 2001-5700 (Bankr. E.D. Pa. 2001). *But see In re Abatement Environmental Resources, Inc.*, 301 B.R. 830, 832–36, 92 A.F.T.R.2d 2003-5242 (D. Md. 2003), aff'd on other grounds, 102 Fed. Appx. 272, 93 A.F.T.R.2d 2004-2655 (4th Cir. 2004) (employing state law immunity other than sovereign immunity to preclude creditor' s predicate action to recover taxes); *In re Anton Motors, Inc.*, 177 B.R. 58, 65–66 (Bankr. D. Md. 1995) (same); *cf. In re Grubbs Const. Co.*, 321 B.R. 346, 351–52, 44 Bankr. Ct. Dec. (CRR) 109 (Bankr. M.D. Fla. 2005) (applying sovereign immunity to creditor' s predicate action in reliance on prior Eleventh Circuit precedent holding the Bankruptcy Code' s abrogation of state sovereign immunity unconstitutional under the Eleventh Amendment, a precedent since overruled by *Central Virginia Community College v. Katz*, 546 U.S. 356, 126 S. Ct. 990, 163 L. Ed. 2d 945, 45 Bankr. Ct. Dec. (CRR) 254, 54 Collier Bankr. Cas. 2d (MB) 1233, Bankr. L. Rep. (CCH) P 80443 (2006)).

[57]Equip. Acquisition, 742 F.3d at 744–45 (citing 740 Ill. Comp. Stat. Ann. 160/5(a)(2), 160/10).

ninth payment solely on the legal issue whether the IRS's sovereign immunity had been abrogated with respect to the actual creditor identified as having the right to avoid such payment.[58]

Stating that the issue was one of first impression in the courts of appeals,[59] and recognizing that its holding was contrary to every bankruptcy and district court that had addressed the issue in the context of the federal government, the Seventh Circuit held that the Bankruptcy Code's abrogation of sovereign immunity did not apply to the actual creditor's predicate action.[60] The court of appeals criticized the reasoning of the lower courts that had reached the opposite conclusion, stating that these courts had focused too much on section 106 and not enough on section 544.[61] First, the Seventh Circuit disagreed with the lower courts' conclusion that the abrogation of sovereign immunity in section 544 would be rendered meaningless if the sovereign immunity still pertained to the actual creditor's predicate action, observing that state taxing authorities could waive their own sovereign immunity in their state courts, and that section 544 contained more than just the ability to use the avoiding powers of an actual creditor, which is found in section 544(b).[62] Specifically, section 544(a) permits the trustee to avoid transfers that are avoidable by judicial lien creditors, execution creditors, and bona purchasers of real property as of the date of the petition, whether or not such creditors or purchasers actually exist.[63] Known as the "strong arm clause,"[64] which allows the trustee to avoid unper-

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[58]Equip. Acquisition, 742 F.3d at 745.

[59]Equip. Acquisition, 742 F.3d at 748. The court distinguished the prior unpublished decision of the Fourth Circuit in *In re Abatement Environmental Resources, Inc.*, 102 Fed. Appx. 272, 274 n.2, 93 A.F.T.R.2d 2004-2655 (4th Cir. 2004), noting that the one sentence in a footnote that addressed the issue was dicta in light of the court's resolution of the case on other grounds. Equip. Acquisition, 742 F.3d at 748 n.2.

[60]Equip. Acquisition, 742 F.3d at 748–49.

[61]Equip. Acquisition, 742 F.3d at 749.

[62]Equip. Acquisition, 742 F.3d at 749.

[63]11 U.S.C.A. § 544(a)(1) to (3).

[64]*E.g., Schlossberg v. Barney*, 380 F.3d 174, 177, Bankr. L. Rep. (CCH) P 80148, 94 A.F.T.R.2d 2004-5505 (4th Cir. 2004); *In re Ozark Restaurant Equipment Co., Inc.*, 816 F.2d 1222, 1226, 16 Bankr. Ct. Dec. (CRR) 134, 16 Collier Bankr. Cas. 2d (MB) 1148, Bankr. L. Rep. (CCH) P 71780 (8th Cir. 1987). The Seventh Circuit called it the "strong-arm power." Equip. Acquisition, 742 F.3d at 749.

fected liens and unrecorded transfers of real property,[65] section 544(a) may be employed against governmental units despite claims of sovereign immunity.[66] The court of appeals observed that nowhere in the enumeration of Bankruptcy Code provisions in section 106(a)(1) did Congress include subdivisions, and decided that a provision was included in the list if any part of it included something for which sovereign immunity should be waived.[67]

The Seventh Circuit rejected arguments based on the legislative history, which it found unhelpful, and on policy favoring maximizing creditors' recoveries even at the expense of the federal government, which occurs elsewhere in the Code.[68] The court identified a countervailing concern of limiting the exposure of federal tax revenues to attack on various state law theories, which could have reach-back periods longer than that of the Bankruptcy Code.[69] Finally, the court stated that the substantive requirements of section 544(b) were unambiguous, and these include the actual creditor's ability to avoid the transfer to the federal government. Congress did not unmistakably waive this requirement in section 106, and the court declined to find an implicit waiver.[70]

Despite its initiation of a contrary result, the Seventh Circuit's analysis deserves to be followed. The lower courts' reasoning that, without the second waiver of sovereign immunity (with respect to the actual creditor's predicate action), the inclusion of section 544 in section 106(a)(1) would be rendered meaningless, does not withstand scrutiny. As the Seventh Circuit recognized, the reference to a "governmental unit" in section 106 does not

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[65]*E.g., In re Kors, Inc.*, 819 F.2d 19, 22, 16 Bankr. Ct. Dec. (CRR) 162, Bankr. L. Rep. (CCH) P 71814, 3 U.C.C. Rep. Serv. 2d 1957 (2d Cir. 1987) (unperfected liens); *McCannon v. Marston*, 679 F.2d 13, 14–16, 9 Bankr. Ct. Dec. (CRR) 245, 6 Collier Bankr. Cas. 2d (MB) 875, Bankr. L. Rep. (CCH) P 68714 (3d Cir. 1982) (unrecorded transfers of real property).

[66]Equip. Acquisition, 742 F.3d at 749.

[67]Equip. Acquisition, 742 F.3d at 749.

[68]Equip. Acquisition, 742 F.3d at 749–50; *see* 11 U.S.C.A. §§ 724(b) (subordinating tax liens), 726(a)(4) (providing for distribution for allowed claims for penalties, including prepetition tax penalties, after all other allowed timely and tardily filed claims).

[69]Equip. Acquisition, 742 F.3d at 750.

[70]Equip. Acquisition, 742 F.3d at 751; *see F.A.A. v. Cooper*, 132 S. Ct. 1441, 1448, 182 L. Ed. 2d 497 (2012) (requiring waivers of sovereign immunity to be "unequivocally expressed" and ambiguities in statutory language to be construed in favor of immunity).

distinguish between the federal government and state and local governments.[71] Some governmental units may enforce tax obligations through judicial liens,[72] which, if unperfected, are susceptible to avoidance under the "strong arm" clause of section 544(a). Moreover, as the Seventh Circuit observed, it is conceivable that a state government or instrumentality could institute an action that would have the effect of waiving sovereign immunity for a fraudulent transfer counterclaim by an actual creditor, which would enable the trustee's use of section 544(b) in such instance.[73] Most persuasively, the structure of section 106(a)(1), which lists the entirety of Bankruptcy Code sections without specifying subdivisions or qualifications, supports the Seventh Circuit's conclusion that Congress included a section in the list if any possible employment of that section could be resisted by the invocation of sovereign immunity by any governmental unit.[74] Therefore, the pursuit of the IRS as a fraudulent transferee will likely be limited to the two-year reach-back period in section 548 of the Bankruptcy Code.

Tax Sharing Agreements and Trusts

When an affiliated group of corporations that has availed itself of the privilege of filing a consolidated federal income tax return[75] is entitled to a refund, the common parent of the group is in bankruptcy, and the subsidiary whose loss gave rise to the refund is not, the appropriate recipient of the refund is called into question. The Internal Revenue Code does not direct the allocation of the refund.[76] The Treasury Regulations[77] make the com-

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[71]The definition of "governmental unit" in 11 U.S.C.A. § 101(27), includes the United States, "State," which is defined in 11 U.S.C.A. § 101(52), and "municipality," which is defined in 11 U.S.C.A. § 101(40).

[72]11 U.S.C.A. § 101(36) defines "judicial lien" as a "lien obtained by judgment, levy, sequestration, or other legal or equitable process or proceeding." In New York, for example, tax obligations are enforced by tax warrants, which are deemed to be judgments. N.Y. Tax Law § 692(c) to (e); *Abrahams v. New York State Tax Com'n*, 131 Misc. 2d 594, 500 N.Y.S.2d 965 (Sup 1986).

[73]Equip. Acquisition, 742 F.3d at 749.

[74]Equip. Acquisition, 742 F.3d at 749.

[75]26 U.S.C.A. § 1501.

[76]*In re Bob Richards Chrysler-Plymouth Corp., Inc.*, 473 F.2d 262, 264, 73-2 U.S. Tax Cas. (CCH) P 9482, 31 A.F.T.R.2d 73-1222 (9th Cir. 1973); *accord Capital Bancshares, Inc. v. Federal Deposit Ins. Corp.*, 957 F.2d 203, 206, 92-1 U.S. Tax Cas. (CCH) P 50201, 69 A.F.T.R.2d 92-1025 (5th Cir. 1992); *Jump v. Manchester Life & Cas. Management Corp.*, 579 F.2d 449, 452, 78-2 U.S. Tax Cas. (CCH) P 9557, 42 A.F.T.R.2d 78-5275 (8th Cir. 1978); *see In re Consolidated*

mon parent the agent for the group,[78] but that status is for the convenience and protection of the IRS.[79] Courts permit the members of the group to agree on the disposition of the refund,[80] and that is often one of the subjects of a tax sharing agreement.[81]

FGH Liquidating Trust, 325 B.R. 564, 566–67, 2005-2 U.S. Tax Cas. (CCH) P 50448, 95 A.F.T.R.2d 2005-2126 (Bankr. S.D. Miss. 2005). *See also United Dominion Industries, Inc. v. U.S.*, 2001-2 C.B. 379, 532 U.S. 822, 826, 121 S. Ct. 1934, 150 L. Ed. 2d 45, 2001-1 U.S. Tax Cas. (CCH) P 50430, 87 A.F.T.R.2d 2001-2377 (2001) (observing that the Internal Revenue Code "permits the group to file a single consolidated return, 26 U.S.C. § 1501, and leaves it to the Secretary of the Treasury to work out the details by promulgating regulations governing such returns, § 1502").

[77]The Secretary of the Treasury is empowered to prescribe rules and regulations for the enforcement of the Internal Revenue Code. 26 U.S.C.A. § 7805(a). The final income tax regulations are set forth in Part 1 of title 26 of the Code of Federal Regulations, 26 C.F.R. §§ 1.0-1 to 1.1563-4.

[78]26 C.F.R. § 1.1502-77(a)(1)(i). The common parent files claims for refunds, and any refund is made directly to and in the name of the common parent. 26 C.F.R. § 1.1502-77(a)(2)(v). Exceptions to this general rule are permitted. The Internal Revenue Code allows the Secretary of the Treasury to promulgate regulations concerning refunds to statutory or court-appointed fiduciaries of insolvent members of affiliated groups that file consolidated tax returns. 26 U.S.C.A. § 6204(k). The Treasury Regulations issued pursuant to this authority give the IRS discretion to pay certain refunds to the appropriate fiduciaries in the case of insolvent financial institutions where the fiduciary is the Federal Deposit Insurance Corporation, the Resolution Trust Corporation, or another entity established by federal law or a federal agency specifically identified by the IRS for this purpose. 26 C.F.R. § 301.6402(a) to (b), (g).

[79]Jump, 579 F.2d at 452; *accord In re Prudential Lines Inc.*, 928 F.2d 565, 571, 21 Bankr. Ct. Dec. (CRR) 838, 24 Collier Bankr. Cas. 2d (MB) 1503, Bankr. L. Rep. (CCH) P 73863, 92-2 U.S. Tax Cas. (CCH) P 50491, 67 A.F.T.R.2d 91-972 (2d Cir. 1991).

[80]*See* Prudential Lines, 928 F.2d at 571; Jump, 579 F.2d at 452; Bob Richards, 473 F.2d at 264.

[81]In the absence of an agreement, the law of unjust enrichment may require that the common parent be treated as an agent required to deliver the refund to the group member whose losses generated it. Bob Richards, 473 F.2d at 265; *accord In re Revco D.S., Inc.*, 111 B.R. 631, 637–38 (Bankr. N.D. Ohio 1990); *see In re First Cent. Financial Corp.*, 269 B.R. 481, 500, 38 Bankr. Ct. Dec. (CRR) 190, Bankr. L. Rep. (CCH) P 78569, 2002-1 U.S. Tax Cas. (CCH) P 50186 (Bankr. E.D. N.Y. 2001), subsequently aff'd, 377 F.3d 209, 43 Bankr. Ct. Dec. (CRR) 89, 52 Collier Bankr. Cas. 2d (MB) 760, 94 A.F.T.R.2d 2004-5304 (2d Cir. 2004). It should be noted, however, that the *Bob Richards Chrysler-Plymouth* case was decided prior to the enactment of the Bankruptcy Code, and therefore, did not consider the Code's expansion of the definition of "claim" to include the "right to an equitable remedy for breach of performance if such breach gives rise to a right of payment." 11 U.S.C.A. § 101(5)(B). *See generally*, Alec P. Ostrow, *The Equitable Claim in Bankruptcy, or What's in a Claim? That Which*

Therefore, the relationship between the parties created by the tax sharing agreement determines the fate of the refund.[82]

Section 541(d) of the Bankruptcy Code provides that if a debtor holds legal title to an asset, but not an equitable interest, the bankruptcy estate contains only the legal title, but not the equitable interest.[83] Consequently, if the debtor holds the refund as agent or in trust, only the legal title to the refund is property of the estate, plus any beneficial interest the debtor may have. On the other hand, if the debtor is merely obligated to pay in accordance with a prescribed formula, a debtor-creditor relationship is created, the refund is property of the estate, and the other members of the group have unsecured claims. Several decisions last year applied state agency and trust law to the construction of tax sharing agreements to resolve the issue whether the non-debtor subsidiary is entitled to the refund itself or is relegated to the status of an unsecured creditor. In what may or may not be a series of stunning coincidences, each of the debtors was a bank holding company and each of the subsidiaries was a failed bank taken over by the Federal Deposit Insurance Corporation ("FDIC").[84]

Two decisions from the Eleventh Circuit within one month awarded the tax refunds to the non-debtor subsidiaries, based on

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We Call an Equitable Remedy?, 2008 Norton Ann. Survey Bankr. L. 77 (discussing the elements of such a claim). This issue was not addressed in either *Revco*, in which there was no tax sharing agreement, or *First Cent. Fin. Corp.*, in which there was a tax sharing agreement.

[82]*See* First Cent. Fin. Corp., 269 B.R. at 490.

[83]11 U.S.C.A. § 541(d).

[84]*In re NetBank, Inc.*, 729 F.3d 1344, 58 Bankr. Ct. Dec. (CRR) 118, 112 A.F.T.R.2d 2013-6044 (11th Cir. 2013), petition for certiorari filed (U.S. June 9, 2014); *In re BankUnited Financial Corp.*, 727 F.3d 1100, 58 Bankr. Ct. Dec. (CRR) 95, 2013-2 U.S. Tax Cas. (CCH) P 50472, 112 A.F.T.R.2d 2013-5729 (11th Cir. 2013), cert. denied, 134 S. Ct. 1505, 188 L. Ed. 2d 388 (2014); *In re Imperial Capital Bancorp, Inc.*, 492 B.R. 25, 58 Bankr. Ct. Dec. (CRR) 2 (S.D. Cal. 2013), appeal dismissed, (9th Cir. 13-56236)(Aug. 9, 2013); *F.D.I.C. v. AmFin Financial Corp.*, 490 B.R. 548, 57 Bankr. Ct. Dec. (CRR) 205 (N.D. Ohio 2013), rev'd and remanded on other grounds, 2014 WL 3057097 (6th Cir. 2014); *In re Downey Financial Corp.*, 499 B.R. 439, 58 Bankr. Ct. Dec. (CRR) 149, 112 A.F.T.R.2d 2013-6407 (Bankr. D. Del. 2013); *see also In re Indymac Bancorp, Inc.*, 554 Fed. Appx. 668, 113 A.F.T.R.2d 2014-1844 (9th Cir. 2014)(mem.), aff' g *In re IndyMac Bancorp Inc.*, 2012 WL 1951474 (C.D. Cal. 2012), aff'd, 554 Fed. Appx. 668, 113 A.F.T.R.2d 2014-1844 (9th Cir. 2014), adopting *In re IndyMac Bancorp, Inc.*, 2012 WL 1037481 (Bankr. C.D. Cal. 2012), report and recommendation adopted, 2012 WL 1951474 (C.D. Cal. 2012), aff'd, 554 Fed. Appx. 668, 113 A.F.T.R.2d 2014-1844 (9th Cir. 2014)) .

the construction of very different tax sharing agreements.[85] In the earlier decision, the agreement[86] contained the following relevant provisions: the bank, rather than the debtor holding company, paid the taxes directly to the IRS; and the bank, rather than the debtor holding company, was required to distribute any tax refund to the group members in accordance with the allocation prescribed in the agreement.[87] Significantly, the agreement failed to specify when, or even that, the debtor holding company was to deliver the tax refund it received from the IRS to the bank, so the bank could carry out its contractual obligation to distribute the refund to the group members. Nevertheless, the agreement clearly implied such an obligation on the part of the debtor holding company.[88] The agreement also failed to specify the ownership of the refund.[89]

The bankruptcy court had construed the agreement to create a debtor-creditor relationship because there was no language requiring the debtor holding company to hold the refund in a trust or agency capacity, and there was language such as "payables" and "receivables."[90] On direct appeal,[91] the Eleventh Circuit reversed.[92] Relying on the absence of any indicia of a debtor-creditor relationship, such as a fixed interest rate, a fixed maturity date, or the ability to accelerate the debt upon default, and the absence of any language authorizing the debtor holding company to retain the refund, the court held that the agreement did not create a debtor-creditor relationship between the debtor

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[85]NetBank, 729 F.3d at 1347, 1352; BankUnited, 727 F.3d at 1108–09.

[86]The agreement chose Delaware law for its interpretation; BankUnited, 727 F.3d at 1105. Delaware law provides that ambiguous contracts must be read to determine the parties' intent from the facts and circumstances surrounding the transaction. BankUnited, 727 F.3d at 1107 (citing *Rohner v. Niemann*, 380 A.2d 549, 552 (Del. 1977)).

[87]BankUnited, 727 F.3d at 1105–06.

[88]BankUnited, 727 F.3d at 1106.

[89]BankUnited, 727 F.3d at 1107.

[90]BankUnited, 727 F.3d at 1107; *In re BankUnited Financial Corp.*, 462 B.R. 885, 900–01, 55 Bankr. Ct. Dec. (CRR) 220, 2011-2 U.S. Tax Cas. (CCH) P 50734, 108 A.F.T.R.2d 2011-7356 (Bankr. S.D. Fla. 2011), judgment rev'd, 727 F.3d 1100, 58 Bankr. Ct. Dec. (CRR) 95, 2013-2 U.S. Tax Cas. (CCH) P 50472, 112 A.F.T.R.2d 2013-5729 (11th Cir. 2013), cert. denied, 134 S. Ct. 1505, 188 L. Ed. 2d 388 (2014).

[91]The bankruptcy court issued a certification, pursuant to 28 U.S.C.A. § 158(d)(2)(A), for a direct appeal, which the court of appeals permitted. BankUnited, 727 F.3d at 1105.

[92]BankUnited, 727 F.3d at 1109.

holding company and the bank.[93] Rather, the court likened the debtor holding company's obligation to hold the received refund intact pending delivery to the bank, which had the responsibility to distribute the apportioned refund, to an escrow arrangement, and enforced the parties' intention to turn over the funds received to the bank.[94]

The agreement in the later Eleventh Circuit decision had different provisions from those construed in the earlier decision.[95] This agreement provided for the debtor holding company to pay the any refunds attributed to subsidiaries not later than 30 days after receipt of the refund[96] or the election to take a credit in lieu of a refund,[97] and in a section referred to as procedural, appointed the debtor holding company as the agent for the members of the consolidated group with respect to refunds.[98] Significantly, however, this agreement stated that it intended to allocate tax liability in accordance with the Interagency Statement on Income Tax Allocation in a Holding Company Structure.[99] In particular, the agreement adopted a provision taken directly from the interagency policy statement that the tax settlements should result in "no less favorable treatment to the Bank Affiliated Group than if it had its income tax return as a separate entity."[100]

Once again, the lower courts had construed the agreement to create a debtor-creditor relationship, focusing again on the lack of language requiring the segregation of the refund, the ability of the debtor holding company to use the refund for 30 days, the

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[93]BankUnited, 727 F.3d at 1108.

[94]BankUnited, 727 F.3d at 1108–09.

[95]This agreement chose Georgia law for its interpretation. NetBank, 729 F.3d at 1349. Georgia law also provides that an ambiguous contract is to be interpreted in light of the circumstances under which it was entered into, and particularly the purpose for the particular language used. NetBank, 729 F.3d at 1350 (citing *Horwitz v. Weil*, 275 Ga. 467, 569 S.E.2d 515, 517 (2002)).

[96]NetBank, 729 F.3d at 1347.

[97]Because the debtor holding company may treat the entitlement to a refund as a credit against future tax liability. NetBank, 729 F.3d at 1347, 1351.

[98]NetBank, 729 F.3d at 1348.

[99]63 Fed. Reg. 64,757 (Nov. 23, 1998). The policy statement was issued jointly by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the FDIC, and the Office of Thrift Supervision "to provide guidance to institutions regarding the allocation and payment of taxes among a holding company and its depository institution subsidiaries." 63 Fed. Reg. 64,757, 64,757 (Nov. 23, 1998).

[100]NetBank, 729 F.3d at 1348; *see* 63 Fed. Reg. 64,757, 64,759 (Nov. 23, 1998).

requirement to pay an attributed refund to a subsidiary even if no refund is actually received.[101] The bankruptcy court had discounted the debtor's appointment as agent as merely procedural, and the agreement's invocation of the interagency policy statement as pertaining solely to allocation issues, and lacking the force of law.[102] The Eleventh Circuit disagreed, giving great weight to the agreement's adoption of the interagency policy statement.[103]

The court of appeals recognized that the aspects of the agreement that had been relied on by the bankruptcy court contraindicated the result it reached.[104] Nevertheless, the court treated these contraindications as rendering the agreement ambiguous, thus requiring the resort to the circumstances of the agreement and its use of particular language, especially the adoption of the interagency policy statement, to determine the parties' intent.[105] This intent, like that of the adopted policy statement, was to treat the each member of the group's entitlement to a refund in the same manner as if each member had filed a separate tax return, and to treat the debtor holding company such member's agent. Consequently, the debtor held the refund in such capacity.[106] With regard to the debtor holding company's obligation to pay an allocated refund even if an actual refund had not been received, the Eleventh Circuit stated that it need not decide the characterization of such an obligation, because the case before it did not present such a fact pattern.[107]

The bankruptcy court for the District of Delaware, which had the benefit of both Eleventh Circuit decisions, reached the opposite conclusion with respect to the tax sharing agreement in its case.[108] The agreement described the intent of the parties to establish a method for allocating the tax liabilities of the members

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[101]NetBank, 729 F.3d at 1347–49; *In re NetBank, Inc.*, 459 B.R. 801, 811–15 (Bankr. M.D. Fla. 2010), judgment aff'd, 2012 WL 2383297 (M.D. Fla. 2012), rev'd, 729 F.3d 1344, 58 Bankr. Ct. Dec. (CRR) 118, 112 A.F.T.R.2d 2013-6044 (11th Cir. 2013), petition for certiorari filed (U.S. June 9, 2014).

[102]NetBank, 729 F.3d at 1349; NetBank Bankr. Ct., 459 B.R. at 816–19.

[103]NetBank, 729 F.3d at 1349.

[104]NetBank, 729 F.3d at 1351.

[105]NetBank, 729 F.3d at 1351.

[106]NetBank, 729 F.3d at 1351–52.

[107]NetBank, 729 F.3d at 1351.

[108]Downey, 499 B.R. at 445. Unlike the two Eleventh Circuit cases, an anticipated refund, rather than an actual one, was the subject of the dispute. Moreover, the Chapter 7 trustee of the holding company and the FDIC had filed

of the consolidated group, paying such liabilities, compensating members for the use of their losses and tax credits, and allocating and paying any refund.[109] The debtor holding company was given broad authority with respect to the filing of tax returns, the ability to claim a refund, the resolution of issues with the IRS, and the determination whether to receive or apply refunds to future tax liability.[110] Finally, the agreement required the debtor holding company to pay allocated refunds to group members within seven days of receipt of an actual refund or the application of the refund to future taxes.[111]

The bankruptcy court determined that the agreement established a debtor-creditor relationship. In reaching this result, the court found that the agreement was not ambiguous, created "fungible payment obligations" on the part of the debtor holding company,[112] contained no escrow or segregation requirements and no restrictions on the debtor's use of any refund received,[113] and delegated substantial authority to the debtor.[114] Distinguishing the Eleventh Circuit cases, the bankruptcy court emphasized that the debtor itself in its case had the obligation to pay ap-

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conflicting forms with the IRS, which led to separate litigation in the Court of Federal Claims to liquidate the amount of the refund, and a separate issue before the bankruptcy court whether the FDIC's actions violated the automatic stay. Downey, 499 B.R. at 449–52. In light of the settlement in the Court of Federal Claims, and the cessation of activity by the FDIC in compliance with prior orders of the bankruptcy court, the bankruptcy court determined that the issue of stay violations had been rendered moot. Downey, 499 B.R. at 471.

[109]Downey, 499 B.R. at 447.

[110]Downey, 499 B.R. at 448.

[111]Downey, 499 B.R. at 448.

[112]Downey, 499 B.R. at 453–57. The term "fungible payment obligations" was also used by the bankruptcy court in *IndyMac*, 2012 WL 1037481 at *13. The author's research has not disclosed an earlier use of this term in reported decisions.

[113]Downey, 499 B.R. at 460 (citing *In re Black & Geddes, Inc.*, 35 B.R. 830, 836, 1984 A.M.C. 451 (Bankr. S.D. N.Y. 1984)). The lack of a prohibition on the recipient's use of funds or commingling them with its own strongly implies a debtor-creditor relationship. *In re Coupon Clearing Service, Inc.*, 113 F.3d 1091, 1101, 30 Bankr. Ct. Dec. (CRR) 1105, Bankr. L. Rep. (CCH) P 77411, 32 U.C.C. Rep. Serv. 2d 962 (9th Cir. 1997); *In re Koreag, Controle et Revision S.A.*, 961 F.2d 341, 353, 26 Collier Bankr. Cas. 2d (MB) 1200, Bankr. L. Rep. (CCH) P 74552, 17 U.C.C. Rep. Serv. 2d 1036 (2d Cir. 1992), aff'd in part, 1992 WL 200748 (S.D. N.Y. 1992).

[114]Downey, 499 B.R. at 461–62.

portioned refunds, as opposed to its bank subsidiary,[115] and the agreement did not adopt the interagency policy statement and its agency implications.[116]

Notably, relying on governing California law, the court refused to consider the extrinsic evidence of intent of an agency relationship proffered by the FDIC.[117] The declaration of the fact witness was rejected, because he was not a signatory to the agreement, even though he alleged he was one of its drafters, and the agreement itself, which was an integrated contract, contained a statement of its intent that did not include any reference to agency.[118] The court disregarded the expert witness's declaration because contract interpretation is a matter for the court, and expert testimony on such an issue is inadmissible.[119] Significantly, the court also discounted the undisputed evidence that the prior refund payments, although payable to the debtor, were in fact deposited into the subsidiary-bank's account.[120] Since the refund checks were payable to the debtor, the deposit into the bank's account could not have occurred without the debtor's express consent. Moreover, the consolidated refund, although contractually required to be apportioned, was transmitted in a single check, which could be deposited in only one account, followed by instructions for distribution of the proceeds.[121] The bank's role in depositing the check and carrying out the apportionment instructions at the debtor's direction was deemed "ministerial."[122]

Concluding its analysis, the court expressly rejected three trust theories argued by the FDIC. There was no express trust, because

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[115]Downey, 499 B.R. at 457–58. *Contra*, BankUnited, 727 F.3d at 1106.

[116]Downey, 499 B.R. at 459. *Contra*, NetBank, 729 F.3d at 1351.

[117]Downey, 499 B.R. at 462–63. The court quoted *Pacific Gas & Elec. Co. v. G. W. Thomas Drayage & Rigging Co.*, 69 Cal. 2d 33, 69 Cal. Rptr. 561, 442 P.2d 641, 645–46, 40 A.L.R.3d 1373 (1968), for the proposition that under California law, a court should make a preliminary assessment of all credible evidence of the contracting parties' intent, and after such preliminary assessment, if the court concludes that the language of the contract is fairly susceptible to an interpretation contended for, the court may admit the extrinsic evidence.

[118]Downey, 499 B.R. at 463.

[119]Downey, 499 B.R. at 463–64.

[120]Downey, 499 B.R. at 449, 464.

[121]Downey, 499 B.R. at 465–66.

[122]Downey, 499 B.R. at 466. The court also declined to credit proffered evidence of how the obligations were recorded on the debtor's books and records in public filings, reasoning that such records and public statements were consistent with the debtor's allocation obligations under the agreement. Downey, 499 B.R. at 466.

of the lack of restrictions in the agreement on the debtor's use of the refund.[123] The remedy of a constructive trust was inappropriate, because wrongdoing was required and there were no allegations or evidence that the debtor had committed any wrongdoing.[124] A resulting trust, viewed under California law as an "intention-enforcing" trust, as distinguished from a "fraud-rectifying trust,"[125] was similarly inapplicable, because the court, invoking its prior analysis, discerned no intention for the debtor to hold the refund in trust.[126] Ultimately, as an equitable remedy requiring an equitable ground for intervention, the court perceived no unjust enrichment of the debtor, since this equitable analysis in bankruptcy must consider the effect on the debtor's other creditors.[127]

This last analysis raises the general issue of the enforcement of equitable trusts in bankruptcy. Equitable trusts and bankruptcy enjoy an uneasy relationship.[128] Bankruptcy policy disfavors secret or unrecorded interests in property.[129] This is reflected, among other places, in the "strong arm" clause.[130] On the other hand, the Bankruptcy Code expressly limits the estate's interest, if the debtor has bare legal title, but no equitable interest.[131]

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[123]Downey, 499 B.R. at 467–68.

[124]Downey, 499 B.R. at 468.

[125]Downey, 499 B.R. at 468 (quoting *Fidelity Nat. Title Ins. Co. v. Schroeder*, 179 Cal. App. 4th 834, 101 Cal. Rptr. 3d 854, 864 (5th Dist. 2009)).

[126]Downey, 499 B.R. at 469.

[127]Downey, 499 B.R. at 470; *see* First Cent. Fin. Corp., 377 F.3d at 218.

[128]*In re Omegas Group, Inc.*, 16 F.3d 1443, 1451, 25 Bankr. Ct. Dec. (CRR) 413, 30 Collier Bankr. Cas. 2d (MB) 1019, Bankr. L. Rep. (CCH) P 75722, 1994 FED App. 0051P (6th Cir. 1994) ("A constructive trust is fundamentally at odds with the general goals of the Bankruptcy Code.") (internal quotation and citation omitted) *with In re Howard's Appliance Corp.*, 874 F.2d 88, 93, Bankr. L. Rep. (CCH) P 72986, 8 U.C.C. Rep. Serv. 2d 344 (2d Cir. 1989) ("Congress plainly excluded [from the estate] property of others held by the debtor in trust at the time of the filing of the petition.") (internal quotation and citation omitted).

[129]*In re Aiolova*, 496 B.R. 123, 132 (Bankr. S.D. N.Y. 2013) (Lifland, J.); *accord In re Canney*, 284 F.3d 362, 374, 39 Bankr. Ct. Dec. (CRR) 57, 47 Collier Bankr. Cas. 2d (MB) 1508, Bankr. L. Rep. (CCH) P 78610 (2d Cir. 2002).

[130]11 U.S.C.A. § 544(a).

[131]11 U.S.C.A. § 541(d).

State constructive or resulting trust law may operate to invest an equitable interest in an entity other than the estate.[132]

The Second Circuit, which has imposed a constructive trust in a bankruptcy case,[133] but rejected it in a tax sharing agreement case,[134] has urged caution in awarding to a non-debtor property held in the name of a debtor in light of the different equities in bankruptcy cases.[135] In the consolidated tax refund cases, the lower courts have been supremely reluctant to declare that debtor holding companies hold the refunds in trust or as agent for the benefit of non-debtors.[136] Not so the Eleventh Circuit; but the tax sharing agreements in those two cases have special characteristics.[137] The results in these cases seem to suggest that ordinarily, when the debtor is the common parent in a consolidated group, the refund is property of the estate. The tax sharing agreement must have special characteristics to take it out of the ordinary rule.

Conclusion

The Supreme Court has repeatedly stated that, "[u]nless some federal interest requires a different result, there is no reason why [property] interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding."[138] So, it should come as no surprise that issues arising in the intersec-

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[132]*See Matter of Quality Holstein Leasing*, 752 F.2d 1009, 1013, 12 Bankr. Ct. Dec. (CRR) 1102, 12 Collier Bankr. Cas. 2d (MB) 20, Bankr. L. Rep. (CCH) P 70280 (5th Cir. 1985) ("As a general rule, it must be held that section 541(d) prevails over the trustee's strong-arm powers.").

[133]Howard's Appliance Corp., 878 F.2d at 94.

[134]First Cent. Fin. Corp., 377 F.3d at 217.

[135]*See* First Cent. Fin. Corp., 377 F.3d at 218.

[136]Imperial Capital Bancorp, 492 B.R. at 32–33; AmFin Fin. Corp., 490 B.R. at 553; *In re Vineyard Nat. Bancorp*, 508 B.R. 437 (Bankr. C.D. Cal. 2014); Downey, 499 B.R. at 468–70; *In re IndyMac Bancorp, Inc.*, 2012 WL 1037481, *29 (Bankr. C.D. Cal. 2012), report and recommendation adopted, 2012 WL 1951474 (C.D. Cal. 2012), aff'd, 554 Fed. Appx. 668, 113 A.F.T.R.2d 2014-1844 (9th Cir. 2014).

[137]NetBank, 729 F.3d at 1349 (intent to adopt the interagency policy statement and its agency principles); BankUnited, 727 F.3d at 1108–09 (requiring the non-debtor subsidiary, the bank, to distribute the refund).

[138]*Raleigh v. Illinois Dept. of Revenue*, 2000-2 C.B. 109, 530 U.S. 15, 20, 120 S. Ct. 1951, 147 L. Ed. 2d 13, 36 Bankr. Ct. Dec. (CRR) 39, 43 Collier Bankr. Cas. 2d (MB) 869, Bankr. L. Rep. (CCH) P 78182, 2000-1 U.S. Tax Cas. (CCH) P 50498 (2000) (quoting *Butner v. U.S.*, 440 U.S. 48, 55, 99 S. Ct. 914, 59 L. Ed. 2d 136, 19 C.B.C. 481, Bankr. L. Rep. (CCH) P 67046 (1979)); *accord*, *Travelers Cas. and Sur. Co. of America v. Pacific Gas and Elec. Co.*, 549 U.S. 443, 451,

tion between federal tax and bankruptcy law should be determined by nonbankruptcy law. Remarkably, the issues discussed in this article were also determined by nontax law: state fraudulent transfer, agency and trust law, primarily, but also sovereign immunity law.

In the "midco" transaction cases, the courts of appeals have used state fraudulent transfer law, including the rules governing collapsing transactions, to impose transferee liability on selling shareholders in schemes to avoid taxes in connection with the disposition of C corporations whose assets have large built-in gains. In evaluating the IRS's exposure to fraudulent transfer liability beyond the Bankruptcy Code's two-year reach-back period when an insolvent S corporation pays its shareholder's liability, the Seventh Circuit has departed from the consensus of lower courts, and held that the Bankruptcy Code does not waive the government's sovereign immunity with respect to the predicate action available to an actual unpaid creditor. Finally, in determining the status of an income tax refund when the debtor is the common parent of a consolidated group of affiliated corporations, courts have generally held that the tax sharing agreement creates a debtor-creditor relationship, thus determining that the refund is property of the debtor's estate, unless, as in the two Eleventh Circuit cases, the tax sharing agreement has special characteristics that remove it from the general rule.

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127 S. Ct. 1199, 167 L. Ed. 2d 178, 47 Bankr. Ct. Dec. (CRR) 265, 57 Collier Bankr. Cas. 2d (MB) 314, Bankr. L. Rep. (CCH) P 80880 (2007); *see BFP v. Resolution Trust Corp.*, 511 U.S. 531, 544–45, 114 S. Ct. 1757, 128 L. Ed. 2d 556, 25 Bankr. Ct. Dec. (CRR) 1051, 30 Collier Bankr. Cas. 2d (MB) 345, Bankr. L. Rep. (CCH) P 75885 (1994) ("To displace traditional state regulation . . . the federal statutory purpose must be clear and manifest. Otherwise, the Bankruptcy Code will be construed to adopt, rather than to displace, pre-existing state law.") (internal quotation and citations omitted).