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Troubled Times in Motor City Detroit's Road Out of Bankruptcy Is Likely Long

by Julie Schaeffer

On July 18, in a historic move destined to ignite complex legal battles among parties with much at stake, Detroit became the largest American city to file for bankruptcy.

“Some real benchmark laws could be set here,” said Jim McTevia of McTevia & Associates. “There are many issues that a normal bankruptcy doesn’t cover.”

Specifically, the filing will undoubtedly initiate precedent-setting battles in federal court on a number of matters, including whether public pensions, previously considered sacrosanct under the Michigan constitution, are protected in municipal bankruptcies.

Other benchmark issues, says McTevia, include the treatment of various municipal bonds as to priority, the treatment of collateralized swaps as to secured or unsecured, and

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Work Left To Be Done Second Circuit to Address Unfinished Business Doctrine

by Randall Reese

Lateral partner hiring has become an increasingly important element in large law firms’ growth strategies. *The American Lawyer* reported that nearly 2,700 partners left or joined AmLaw 200 firms during the twelve months ending September 30, 2012. That was nearly ten percent higher than the year earlier. An October 2012 study conducted by LexisNexis and ALM Legal Intelligence found that 75 percent of law firm leaders who were surveyed reported that their firms planned to increase lateral partner hiring over the next five years.

One factor in the increasing movement of partners between firms has been the

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False WARNING Employment Law Does Not Apply to Distressed Investors

by Julie Schaeffer

The United States Bankruptcy Court for the District of Delaware has ruled that a private equity sponsor is not liable for its portfolio company’s alleged violations of the federal Worker Adjustment and Retraining Notification (WARN) Act.

While the decision is good news for investors in troubled companies, says M. Natasha Labovitz, co-head of Debevoise & Plimpton LLP’s business restructuring and workouts group, “private equity sponsors likely will continue to be targets for claimants seeking to recover on employee-related liabilities if a portfolio company fails.”

In 2006, a subsidiary of Sun Capital Partners, a private equity firm, acquired Jevic Transportation. Under the management services agreement, Jevic paid Sun Capital

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the treatment of municipal assets, such as the ownership of works of art located in the Detroit Institute of Arts.

The battle began when Michigan Governor Rick Snyder appointed Kevyn Orr as the city's emergency manager to figure out what to do about Detroit's dire fiscal condition. At the time, Detroit owed around \$18 billion to more than 100,000 creditors, including \$3.5 billion in unfunded obligations and \$5.7 billion in unfunded healthcare liabilities. Orr, says Bill Brandt, President and CEO of Development Specialists, Inc., was perceived by some on the other side as not the easiest person to negotiate with. "They felt that the initial offers were on a 'take-it-or-leave-it' basis," Brandt says. "Their belief was that Orr was initially determined to file a Chapter 9, and therefore was just going through the motions of pretending to bargain."

In response, certain of the pension beneficiaries retained counsel and then took a look at the provisions of the Michigan state constitution that prohibit the alteration or reduction in existing public employee pension benefits. "That provision is in the Michigan constitution and several other states' constitutions because public employees do not participate in the Social Security system," says Brandt. "If you take away their pension plans, they have no safety net."

The creditors filed suit in Ingham County, the county in which the state capital of Lansing is located, seeking to obtain a declaratory judgment against the effort to file a Chapter 9. The creditors argued that the likely singular purpose for filing a Chapter 9 would be to alter or diminish existing city pension plans. "Their argument was that since such alterations are constitutionally prohibited under Michigan law, the state court could intervene to block the filing of a Chapter 9," notes Brandt.

A sign of just how contentious the matter likely will become came when the pension funds were beaten to the courthouse by minutes. The pension funds reportedly delayed their filing by five minutes at the request of attorneys for Governor Snyder – and during those five minutes, Snyder's attorneys filed the bankruptcy petition in Detroit, which generally results in a stay in all other pending lawsuits involving the

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dissolution of large firms in recent years. However, many firms are facing one of the risks of hiring a lateral partner: the risk of unfinished business suits if that partner's old firm dissolves. The outcomes of two cases currently pending before the Second Circuit Court of Appeals, which arise out of the bankruptcies of Coudert Brothers LLP and Thelen LLP, are set to answer the question of whether, under New York law, a client matter that is billed on an hourly basis is property of a law firm, such that the law firm is entitled to the profit earned on the firm's unfinished business upon dissolution.

Notably, the two district court judges whose opinions are being appealed came to opposite answers. In the *Coudert Brothers* case (*Dev. Specialists, Inc. v. Akin Gump Strauss Hauer & Feld LLP*, 480 B.R. 145 (S.D.N.Y. 2012), Judge Colleen McMahon determined that, "the New York Court of Appeals would, if confronted with the issue, conclude that all client matters pending on the date of dissolution are assets of the firm – regardless of how the firm was to be compensated for the work." Conversely, in the *Thelen* case (*Geron v. Robinson & Cole LLP*, 476 B.R. 732 (S.D.N.Y. 2012), Judge William Pauley III held that "New York law does not recognize a debtor law firm's property interest in pending hourly fee matters."

The seemingly straight-forward question at the heart of these cases implicates a number of different statutory and public policy issues. The first and most basic question is whether the New York Partnership Law, which is a codification of the Uniform Partnership Act, recognizes a property interest in unfinished client matters that are billed on an hourly basis. If it does, then the Partnership Law requires every partner to account to his or her former partners for any benefit that that is derived from any use of that property. Judge McMahon answered in the affirmative, holding that "[t]he general rule is that the business of a partnership that is unfinished on the date the partnership dissolves is an asset of the partnership, and must be concluded for the benefit of the dissolved partnership." While Judge Pauley acknowledged that it is "well settled" that pending contingent fee cases are assets of a dissolved partnership under New York law, he noted

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Partners for specified consulting services.

In May of 2008, Jevic filed for Chapter 11 just a day after Jevic's employees had received termination notices.

The problem: Pursuant to the WARN Act, companies with 100 or more employees must provide 60 days advance notice of mass layoffs or plant closings. If they don't, they will find themselves liable for lost wages, benefits, and possibly other damages.

Shortly after Jevic filed for Chapter 11 protection, a class of terminated Jevic employees sued Jevic and Sun Capital Partners under federal and state law for having terminated employees without the required WARN Act notice.

Sun Capital Partners was appropriately named a defendant, the plaintiffs argued, in that it, along with Jevic, was a "single employer" – a concept that was defined by the Third Circuit.

According to the Third Circuit, a party such as Sun Capital Partners is liable under the WARN Act as a single employer if it meets a five-pronged test originally created by the Department of Labor: (1) common ownership, (2) common directors and/or officers, (3) de facto exercise of control, (4) unity of personnel policies, and (5) dependency of operations.

Judge Brendan Linehan Shannon of the United States Bankruptcy Court for the District of Delaware began by applying the five-factor test to the relationship between Sun Capital Partners and Jevic.

According to Shannon, the relationship between the parties indisputably met the first two factors – common ownership and common directors and/or officers.

In regard to the third factor, however, Shannon ruled that Sun Capital Partners did not exercise *de facto* control over Jevic. For WARN Act evaluation, he said, the question was whether Sun Capital Partners was specifically involved in the decision to close facilities and terminate employees, not whether Sun Capital Partners had control as a practical matter because of the ordinary powers of ownership. As was the case, Jevic had hired independent professionals to advise it regarding its deteriorating financial condition, and Sun Capital Partners had not played a role in Jevic's decision to terminate its employees – meaning the relationship didn't meet the third prong of the five-prong test. Labovitz says it's notable, however, that

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Research Report

Who's Who in School Specialty, Inc.

by Francoise C. Arsenault

School Specialty, Inc., headquartered in Greenville, Wisconsin, is one of the nation's largest suppliers of educational products and services, serving about 70 percent of the estimated 130,000 schools in the United States. The company designs, develops, and provides pre-K through grade 12 educators and students with curricula, supplemental learning resources, instructional programs, student assessment tools, and school supplies, including physical education equipment, art supplies, teacher resources, and classroom furniture and equipment. School Specialty offers its more than 75,000 products through its catalogs and websites to public school district, individual private and parochial schools, educators, and individual consumers. The company had revenues of \$712 million in 2012.

School Specialty, which was founded in 1959, was acquired by U.S. Office Products in 1996 and spun off as a public company in 1998. The company has approximately 1,850 employees nationwide, including 450 employees at its headquarters in Greenville and a sales force of about 500. In addition to its headquarters facility, School Specialty leases or owns 15 facilities throughout the U.S., including 3 manufacturing plants. The company is also the parent of two Canadian subsidiaries that are not debtors in the Chapter 11 proceedings.

On January 28, 2013, School Specialty, Inc. and nine affiliated debtors filed for Chapter 11 reorganization in the United States Bankruptcy Court for the District of Delaware. In its bankruptcy filing, the company listed assets of \$494.5 million and debts of \$394.5 million. According to company officials, the recession and state budget cuts were the primary factors in the company's financial problems.

The bankruptcy court approved DIP financing for School Specialty in the amount of \$155 million on February 25, 2013. On May 23, 2013, the court approved the company's second amended Joint Plan of Reorganization. Under the terms of the Plan of Reorganization, School Specialty will reduce its total debt by about 50

percent and will secure approximately \$320 million in new financing from the Bank of America, NA, SunTrust Bank, and Credit Suisse. The company completed its financial restructuring and officially emerged from bankruptcy on June 11, 2013.

The Debtor

Michael P. Lavelle is the President and Chief Executive Officer of School Specialty, Inc. **David Vander Ploeg** is the Chief Financial Officer. **Gerald T. Hughes** is the Chief Administrative Officer and Executive Vice President. **Kathryn Miller** is the Chief Marketing Officer.

Paul, Weiss, Rifkind, Wharton & Garrison, LLP is serving as the bankruptcy counsel. The team includes **Alan W. Kornberg, Jeffrey D. Saferstein, Elizabeth R. McColm, Dale M. Sarro, Tarun M. Stewart, and Jeffrey B. Samuels**, partners, and **Lauren Shumejda, Ann K. Young, Rachel E. Brennan, Margaret A. Phillips, Michael S. Rudnick, David Klein, and Meagan S. Sway**, associates.

Young Conaway Stargatt & Taylor LLP is acting as local bankruptcy counsel to School Specialty. Working on the case are **Pauline K. Morgan, Joel A. Waite, and Sean T. Greecher**, partners, **Curtis J. Crowther**, counsel, and **Maris J. Kandestin, Morgan L. Seward, Laurel D. Roglen, Michael S. Neiburg, Stephanie L. Hansen, and Andrew L. Magaziner**, associates with the firm.

Alvarez & Marsal North America LLC is providing School Specialty with restructuring advisory services and accounting and financial reporting services. **Thomas E. Hill**, a managing director with the firm, is serving as the Chief Restructuring Officer. The team also includes **Nate Arnett**, a senior director, **Nicholas Grossi** and **Prasant Gondipalli**, directors, and **Mark Berger**, an associate.

Godfrey & Kahn, S.C. is special corporate and transactions counsel. Directing the work are **Nicholas A. Kees, Christine Liu McLaughlin, Dennis F. Connolly, James A. Friedman, John E. Donahue, Timothy F. Nixon, and Gene T. Schaeffer, Jr.**, all partners with the firm.

Perella Weinberg Partners LP is acting as the financial advisor. The team includes **Derron S. Slonecker**, a partner, **Agnes K. Tang**, a managing director, **Nikhil V. Menon**, a director, **Jacob J. Czarnick** and **Tulika Garg**, associates, and **Alexandra Almore**, an analyst.

Deloitte & Touche LLP is serving as the independent auditor. **Scott Wilgenbusch**, a partner in the firm's Chicago office, is leading the engagement.

Kekst and Company is the communications and media advisor. **Kimberly Kriger**, a managing director with the firm, heads up the team.

The Official Committee of Unsecured Creditors

The Committee includes **Integrated Resources Holdings, Inc.; S.P. Richards Company; Quad/Graphics, Inc.; and The Bank of New York Mellon Trust Company NA**, as Indenture Trustee.

Brown Rudnick LLP is counsel to the Committee. The team includes **Robert J. Stark** and **Andrew S. Dash**, partners in the firm's New York office, **Steven D. Pohl, Thomas H. Montgomery, and Steven B. Levine**, partners in the Boston office, and **Arkady A. Goldin, Aliza Reicher, Aaron B. Lauchheimer, Kiersten A. Taylor, and Andrew M. Carty**, associates with the firm.

Venable LLP is serving as the co-counsel to the Committee. Working on the case are **Jamie L. Edmonson, Darek S. Bushnaq, Hamid R. Rafatjoo, and Andrew J. Currie**, partners with the firm, and **Laura S. Bouyea**, an associate.

Blackstone Advisory Partners L.P. is providing the Committee with financial advisory services. The team includes **Nicholas P. Leone**, a senior managing director, **Jaime Baird**, a managing director, **Harold Kim**, an associate, and **Philip Harrison**, an analyst.

The Trustee

The U.S. Trustee is **Roberta A. DeAngelis**.

The Judge

The judge is the **Honorable Kevin J. Carey**. □

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city. Ronald King, a lawyer representing Detroit's General Retirement System and the Detroit Police and Fire Retirement System, said he believes the city did not act in good faith. Brandt, for his part, says, "The general feeling I got from some is that this state court effort accelerated the timetable for the Chapter 9 filing."

Regardless, Detroit had filed its Chapter 9 by the time Ingham County Judge Rosemarie Aquilina heard the pension beneficiaries' arguments. She then ordered that the Detroit bankruptcy filing be withdrawn, ruling Snyder and Orr had violated the state constitution.

"If you read the judge's order, she says the purpose of Detroit's Chapter 9 is to diminish the pension plans, which is unconstitutional in Michigan, and therefore the Chapter 9 can't be filed," says Brandt. "Detroit, in turn,

points out that it has not yet diminished the pension plans and no such motion to do so is pending. So the question is, can Judge Aquilina prevent Detroit from filing the Chapter 9?"

Attorney General Bill Schuette has filed an application for Appeals Court consideration of Aquilina's order, asking that the court put a hold on present and future lower-court proceedings. Brandt thinks he'll be successful. "Detroit probably has the right legal argument. The city followed the correct procedure in filing the Chapter 9, and there is no current motion pending to abrogate the pension plans, so Detroit has not yet violated any state constitution prohibitions. And, if there is a constitutional argument about whether you can alter the pension plans, it will likely happen in the context of a Chapter 9."

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that "New York courts have not expanded the unfinished business doctrine to reach pending hourly fee matters."

Judge Pauley then turned to the second line of issues that are presented in considering this question – whether New York public policy is implicated in applying the unfinished business doctrine to hourly fee matters. It is asserted that it would create financial disincentives for partners to continue representing their former clients, which would run counter to New York's "strong commitment to the policy of client choice of attorneys," violate the fee splitting limitations in Rules of Professional Conduct, and act as a restraint on lawyer mobility. Judge Pauley found these considerations compelling, holding that expanding the doctrine to hourly matters "would violate New York's public policy against restrictions on the practice of law" and constitute impermissible fee splitting. Judge McMahon also noted that the public policy concerns presented the "most powerful argument" against applying the unfinished business doctrine to hourly matters. However, she ultimately noted that "accounting for profits in a contingent fee case creates exactly the same type of financial disincentive" and "it makes no sense to hold that imposing on a former partner the duty to account for profit realized on a billable hours case...violates public policy, but imposing the identical duty when the case was handled on contingency does not."

One fundamental difference between the judges appears to be the extent to which each believed that law firm partnerships were unique from other professional partnerships. Judge McMahon rejects the assertion, at least insofar as it relates to the application of the Partnership Law. Judge Pauley, however, asserts that the unique aspects of a law firm partnership do require different results. He notes that a "pending client matter is not an ordinary article of commerce." While Judge McMahon compares an hourly fee matter to an expensive painting in a law firm office, Judge Pauley rejects the comparison outright. He states that "the attorney-client relationship is unique, and applying [a case involving an architecture partnership] to hourly fee legal service contracts would undermine it."

The Second Circuit recently denied a motion to hear the two appeals in tandem. Parties involved in both cases expect that oral arguments will not occur for several months, at the earliest. However, because the issues are largely issues of New York state law, one party believes that it is possible that the Second Circuit may certify one or more of questions to the New York Court of Appeals.

In the next issue of *Turnarounds & Workouts*, the effect of the Second Circuit's ultimate ruling on creditor recoveries in law firm dissolutions and the implications for management of all law firms will be explored. The position of the New York City Bar Association on these issues will also be discussed. □

Calendar

National Association of Bankruptcy Trustees

2013 Annual Convention
August 8–11, 2013
The Greenbrier
White Sulphur Springs, WV
Contact: www.nabt.com

American Bankruptcy Institute

21st Annual Southwest Bankruptcy Conference
August 22–24, 2013
Hyatt Regency Lake Tahoe
Incline Village, NV
Contact: www.abiworld.org

Turnaround Management Association

TMA's 25th Annual Conference
TMA International Headquarters
October 3–5, 2013
Marriott Wardman Park
Washington, DC
Contact: www.turnaround.org

National Conference of Bankruptcy Judges

87th NCBJ Annual Conference
Oct. 30–Nov. 2, 2013
Atlanta, GA
Contact: www.ncbj.org

Association of Insolvency and Restructuring Advisors

12th Annual Advanced
Restructuring & Plan of
Reorganization Conference
November 18, 2013
The Union League Club
New York, NY
Contact: www.airacira.org

Beard Group

20th Annual Conference on
Distressed Investing
December 2, 2013
The Helmsley Park Lane Hotel
New York, NY
Contact: (240) 629-3300

Special Report

Canadian Bankruptcy Law Firms

Firm	Attorneys	Bankruptcy Attnys.	Senior Bankruptcy Partners		Representative Clients/Cases
Aird & Berlis 416-863-1500 www.airdberlis.com	135	15	Harry Fogul Robb English Steven Graff	Richard Epstein Sanj Mitra Sam Babe	Capital Sports Holdings, CCAA application to restructure Forsyth group of companies, CCAA proceedings of Vanguard Shipping (Great Lakes) and Vanship, Palmyra Resort and Spa, insolvency of Precision-Tech, receivership of Copley Corp, CCAA proceedings of Extreme Fitness, dealer agreements with Certified Solar
Alexander Holburn Beaudin + Lang 604-628-2700 www.ahbl.ca	72	8	Sharon M Urquhart Michael Dery David A Garner	Larry J Gwozd Judy A Rost	Landlords in various retail insolvencies, lien claimants in cross border insolvencies, insurers, equipment lessors, suppliers, Minister of Finance, trustees and interim receivers, asset bidders and purchasers, and others
Bennett Jones 416-863-1200 – Toronto 403-298-3100 – Calgary www.bennettjones.com	358	16	S Richard Orzy Ken Lenz Raj Sahni	Kevin Zych Chris Simard	Nortel Networks bondholders, Sino-Forest Corporation, Yellow Media noteholders, OPTI Canada noteholders, Catalyst Paper noteholders, Gateway Casinos secured lenders, AbitibiBowater UCC, Smurfit-Stone UCC, Quebecor World UCC, Newpage bondholders, SkyLink Aviation noteholders, Trident Exploration, and others
Blake, Cassels & Graydon 416-863-2400 www.blakes.com	576	25	Bernard Boucher Kelly Bourassa Milly Chow Sébastien Guy Pamela Huff	William Kaplan Michael McGraw Linc Rogers Peter Rubin Steven Weisz	Alvarez & Marsal, Aveos, Bank of Montreal, Caterpillar Financial, Catalyst Paper, CIBC, Canwest, Cinram, Credit Suisse AG, Ernst & Young, FTI Consulting, Fifth Third Bank, First Leaside, Grant Thornton, Great Basin, JPMorgan Chase, Kraus Carpet, National Bank, Northstar Aerospace, PricewaterhouseCoopers, St Mary's Paper, Sterling Shoes, Timminco Ltd, TD Securities
Cassels Brock & Blackwell 416-869-5300 www.casselsbrock.com	200	16	Joseph Bellissimo John Birch Bill Burden Deborah Grieve	Bruce Leonard Alison Manzer Marc Mercier David Ward	AIG Commercial Equipment Finance, Bank of Montreal, BDO Canada, Business Development Bank of Canada, CapitalSource Finance, Cisco Systems, Crystallex International Corporation, Digital Domain Media Group, Ernst & Young, First Leaside Wealth Management, Govt of Canada/Industry Canada (General Motors and Chrysler Restructurings), UK Pension Protection Fund (Nortel), and others
Dentons Canada f/k/a Frasers 416-863-4511 dentons.com	605	54	Jane Dietrich Ryan Jacobs Shayne Kukulowicz David Mann	Ray Rutman John Sandrelli Roger Simard Michael Wunder	Nortel Networks (UCC), Crystallex (DIP lender), Great Basin Gold (ad hoc bond group), LightSquared (debtor), AVEOS (debtor), Catalyst (first lien lender group), Unity Builders (debtor), Medicam (debtor), First Leaside (rep counsel for Investors) Clients include BMO, RBC, HSBC, Apollo, Tenor Capital, and others
Dickinson Wright 416-777-0101 www.dickinsonwright.com	35	7	Lisa Come Eric Kay David Preger	Mark Shapiro Michael Weinczok	Creditors, debtors and court-appointed officers in bankruptcy, insolvency and restructuring cases, including Johnson Controls Inc, Visteon Corp, Romspen Investment Corporation, Ontario Wealth Management Corporation, MNP Ltd, A Farber & Partners Inc, and SF Partners Inc
Farris, Vaughan, Wills & Murphy 604-684-9151 www.farris.com	91	5	David Gruber Robert Sloman	Rebecca Morse	City of Vancouver (Olympic Village restructuring), Steels Industrial Products (counsel for petitioner), Blackburn Developments (counsel for Streetwise Capital Partners), Catalyst Paper Corp (counsel for a group of 2014 unsecured noteholders and 2016 noteholders), Angiotech Pharmaceuticals (counsel for petitioner)
Fasken Martineau DuMoulin 416-366-8381 www.fasken.com	770	44	John F Grieve Alain Riendeau Aubrey Kauffman Kibben Jackson	Luc Beliveau Stuart Brotman Jon Levin	PwC (Catalyst Paper Corp); Alvarez & Marsal (Sterling Shoes); Catalyst Capital Group (Mobicility); Ernst & Young (Pension Financial Services Canada); Samson Bélair / Deloitte & Touche (Century Mining Corp); HSBC (Bear Mountain); Azure Dynamics; Investissement Québec; FTI Consulting; Canada Deposit Insurance Corp
Gowling Lafleur Henderson 416-862-7525 gowlings.com	750+	78	Colin Brousson David F W Cohen Derrick Tay Thomas Cumming	John McLean Clifton Prophet Patrick Shea Alex MacFarlane	Nortel Networks (CCAA proceedings), FTI Consulting (Sino-Forest Corp CCAA proceedings), Korea Resources Crp and Korean consortium (Boleo Mine Project), KPMG (Great Basin Gold CCAA), Bank of Montreal (Standen's Group of Companies), Bank of Nova Scotia (Unity Builders CCAA), bcIMC Investment Management Corporation (Aviawest CCAA and Receivership), and others
McMillan 416-865-7000 www.mcmillan.ca	330	21	Yoine Goldstein Max Mendelsohn Peter Reardon Andrew J F Kent Sheryl E Seigel Wael Rostom	Adam Maerov Éric Vallières Marc-André Morin Brett Harrison Markus Koehnén	Yellow Media (Bank of Nova Scotia), Great Basin Gold, Catalyst Paper (JPMorgan), Crystallex International, Nortel (Bank of New York Mellon/RPX), Canwest (senior secured/DIP lenders), Homburg Invest (Catalyst Capital Group), Contract Research Solutions (Freeport Financial), Terrace Bay Pulp (Ernst & Young), Grant Forest Products (purchaser of), NewPage Port Hawkesbury (NewPage Corp), Progressive Moulded Products, SKD Company, and others
Stikeman Elliott 416-869-5500 www.stikeman.com	467	34	Jean C Fontaine Marc Barbeau Stephen Hamilton Kevin Kyte Jean Lamothe Matthew Liben Guy P Martel Yves Martineau	Claire Zikovsky Elizabeth Pillon Ashley John Taylor David R Byers Daphne MacKenzie Daniel Murdoch Alex Rose Andrea Boctor	Yellow Media, FTI Consulting Canada (court-appointed monitor of Indalex), Ernst & Young (court-appointed monitor of NewPage Port Hawkesbury, Crystallex, and Landrill), AbitibiBowater (now Resolute Forest Products), Timminco, Deutsche Bank AG, Prizm Income Fund/Prizm LP, Northstar Aerospace, ACE Aviation Holdings, Arctic Glacier – H I G Capital, Baja Mining Corp, Bock, Air Canada, Stichting Homburg Bonds, Contract Research Solutions, Pension Financial Services Canada, Ontario Teachers' Pension Plan, GE
Torys (416) 865-0040 www.torys.com	260	15	Tony DeMarinis Scott Bomhof	David Bish	Canada Pension Plan Investment Board, WestFace Capital, PricewaterhouseCoopers, Brookfield Asset Management Inc, Fairfax Financial Holdings Limited, Nortel Networks Inc, The Cadillac Fairview Corporation Limited, The Toronto-Dominion Bank, Assuris, Globe Specialty Metals, Inc

Worth Reading

Paper Prophets: Fraudulent Accounting and Failed Audits

Author: Tony Tinker

Publisher Beard Books

Softcover: 252 pages

List Price: \$34.95

The author remarks in his update of this work first published in 1985 that “one can now discern some important lessons from this book, especially in relation to the contemporary fiascoes involving accounting and corporate accountability.” Tinker is referring to the spectacular bankruptcies of Enron, WorldCom, and other major U. S. corporations, and the questionable accounting of America Online and others. At the time of its initial publication, *Paper Prophets* presented a new perspective on what had commonly been seen as a largely insular profession. But in this book, Tinker illustrates how accounting practice has social consequences. The connection between accounting and the real world is vividly apparent when Enron employees lose their pensions after their company has successfully hidden its corporate failure through questionable or fraudulent accounting.

Paper Prophets delves into the details of how compromised or outright bogus accounting practices can have harmful effects not only on a corporation, but also segments of the public. Tinker’s exposé of the pollution of the Love Canal in the 1980s is especially instructive. Before Tinker made the connection, hardly anyone would have realized that a company’s accounting practice could affect a region’s environment. But with a prosecuting lawyer’s skill for compiling evidence and building a case, the author does just that, demonstrating the role accounting practices played in the environmental disaster in the area of Niagara Falls.

For years, the Hooker Chemical and Plastics Corporation, a subsidiary of Occidental Petroleum, had been dumping toxic chemicals into Love Canal. Hundreds of families in the area had abandoned their homes after seeing an unusually high number of medical problems, ranging from birth defects to rashes, allergies, and even cancer in family members and neighbors. Eventually, the Environmental Protection Agency and New York State environmental authorities became involved in the situation.

At the time, the Love Canal story was covered by the national media as essentially a story of environmental damage and the health dangers posed to neighboring communities. But, in Tinker’s account, the contamination escaped notice because Hooker Chemical failed to account for the cost of complying with environmental regulations, or the financial liability it might face for not complying with them, in its balance sheet. This resulted in the company overstating its earnings. The government’s case against Hooker Chemical and Occidental Petroleum and the numerous private lawsuits that ensued “established an important precedent” in requiring corporations to report environmental costs in their books.

Tinker makes other fascinating connections between corporate accounting and social consequences. This includes the British government’s bailout of the Slater Walker Company, a leading international financial company that was a favorite of British politicians; dubious new energy companies spawned solely because they make attractive tax shelters; and company executives covering up unfavorable reports from their accountants in the case of the National Student Marketing Corporation.

Tinker’s work remains relevant not only to lay readers, but to all corporate executives rethinking the relationship between business and society. As Tinker contends, an important aspect of this relationship can be found in financial documents. □

The author of previous books and many articles in this field, Tinker is often featured in the media as a commentator on accounting issues.

This book may be ordered by calling 888-563-4573 or by visiting www.beardbooks.com.

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In appealing Aquilina’s order, says Brandt, the debate will involve the interpretation of the federal supremacy clause of the U.S. constitution and whether provisions in the bankruptcy code can override the dictates of a state’s constitution. “Some will argue that the supremacy clause will allow contract, or pension plan, rejections and override the state constitutional prohibition. There will be a debate on that, but if the supremacy clause can override the state constitution regarding the alteration of a pension plan, it can also override the state’s efforts to protect Detroit’s public art from a sale process, which the state legislature recently sought to prohibit. In my opinion, you don’t get to pick and choose what portion of your case the supremacy clause applies.”

Next, U.S. District Judge Steven Rhodes will proceed with hearings, during which he will determine if Detroit is eligible to file for Chapter 9. The Bankruptcy Code, for example, specifies the requirements a municipality must meet in order to file for Chapter 9, and they include that the debtor must be insolvent, it must wish to effect a plan to adjust its debts, and it must have previously negotiated with creditors who hold at least a majority of each class of debt that a forthcoming Chapter 9 plan would impair. “That process will likely take a few weeks or more, at a minimum, as I expect that decision to be the result of a trial,” says Brandt.

Meanwhile, Brandt thinks Rhodes will implement some initial aspects of a Chapter 9, such as the automatic stay. Automatic stays would normally, during a Chapter 9, be issued on most lawsuits, including challenges by pension funds and unions. They would also be issued on most of a city’s bills, including unsecured debts, though Detroit would likely continue to pay secured creditors, including water and sewer bondholders, who have the right to seize city assets if Detroit fails to pay.

Looking ahead, if Judge Rhodes allows the city to move forward with a Chapter 9, Orr would propose a plan of reorganization that would likely involve budget cuts, layoffs, and asset sales. If it wins enough support from creditors – including bondholders, unions, and pension boards – the plan will be put to a vote and, with enough support, the city

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Special Report

Outstanding Investment Banking Firms – 2013

Firm	Senior Professionals	Outstanding Achievements
Blackstone New York, NY 212-583-5000 www.blackstone.com	Tim Coleman Flip Huffard Steve Zelin Nick Leone	Mike Genereux Martin Gudgeon David Riddell
Blackstone New York, NY 212-583-5000 www.blackstone.com	Tim Coleman Flip Huffard Steve Zelin Nick Leone	Mike Genereux Martin Gudgeon David Riddell
Goldman, Sachs & Co New York, NY 212-902-1696 www.gs.com	Bruce Mendelsohn	Roopesh Shah
Goldman, Sachs & Co New York, NY 212-902-1696 www.gs.com	Bruce Mendelsohn	Roopesh Shah
Gordian Group New York, NY 212-486-3600 www.gordiangroup.com	Henry Owsley Peter Kaufman Patricia Caldwell	Dennis McGettigan David Herman
Gordian Group New York, NY 212-486-3600 www.gordiangroup.com	Henry Owsley Peter Kaufman Patricia Caldwell	Dennis McGettigan David Herman
Houlihan Lokey 19 global offices 800-788-5300 www.HL.com	Amit Patel Andrew Miller Andrew Turnbull Brad Geer Chris DiMauro	David Hilty Eric Siegert Eric Winthrop Matthew Niemann Tuck Hardie
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would emerge from bankruptcy. If the plan doesn't win enough support from creditors, the city would have to continue to negotiate with creditors or pursue a cramdown, which would require winning support of a minority of creditors and convincing a judge that dissenting creditors are not being reasonable.

The possible length of the case is being widely debated. Some experts believe it could be accomplished as soon as several months, but Brandt doesn't think that is realistic. "The case began with a great deal of acrimony and is likely only to degenerate into a further level of animus given the cuts being discussed," he says. "As a result, it's likely the case will take some time to play out."

Brandt says it's important to see Detroit's filing for what it is. "A lot of people are saying this portends the falling of urban America, but it doesn't; it's an isolated incident, in many ways as isolated as Harrisburg or Jefferson County were. It's one city with a particular set of troubles that have long been festering. You hear a lot about how corruption has caused this, but corruption didn't drive 1.3 million people out of the city since 1950; the decline of the automotive industry and the commercial reshaping of the Detroit metropolitan area did."

Brandt adds, "Some in the city say the white power structure of Michigan has long sought to isolate the city's problems from affecting the rest of the state. You have a city that's 83 percent black in a state that's 80 percent white. Some suggest that this racial dynamic is one of the reasons that state politicians have been unwilling to come to the aid of the largely Democratically-controlled city. No one seems to want to talk about this, but the racial politics here are one of the things that makes this filing unique." ▣

False, from page 2

Shannon didn't accept Jevic's argument that Sun Capital Partners' decision to stop funding Jevic – which led to Jevic's decision to terminate employees – was an exercise of de facto control. According to Shannon, it was Jevic, not Sun Capital Partners, that "retained the ultimate responsibility for keeping the company alive."

In regard to the fourth and fifth factors, unity of personnel policies and dependency of operations, Shannon again noted that a company's ordinary powers of ownership are not the same as control over day-to-day operations. As Shannon saw it, Sun Capital Partners' management services agreement did not, in and of itself, create any operational dependency, and the two companies were in no other way operationally dependent on one another. According to Shannon, not even Sun Capital Partners' pre-bankruptcy rescue attempts (including a \$1 million investment at the time of the acquisition and a \$2 million guarantee after the business declined) established financial dependency because these investments were outside of the ordinary course of business.

Because only the first two factors favored Jevic, Shannon granted Sun Capital Partners' motion for summary judgment. "The Bankruptcy Court's decision provides some comfort that many of the common hallmarks of the sponsor/portfolio company relationship will not necessarily trigger WARN Act liability at the sponsor level," says Labovitz.

That said, Labovitz thinks private equity firms will continue to be targets for claimants seeking to recover on employee-related liabilities if a portfolio company fails.

"Since significant layoffs and plant closings often occur in the context of

bankruptcy or other financial distress, WARN claimants may be unable to collect amounts owed from a primary employer," she says. "In that situation, they often look for deep-pocketed related parties – such as key investors and/or lenders – against whom they can assert claims."

Moreover, in 2011, a court did hold a private equity firm liable for WARN Act obligations, and similar attempts have been made to hold a private equity firms liable for unpaid pension obligations of bankrupt portfolio companies.

As a result, Labovitz says, investors should avoid becoming directly involved in the personnel decisions of distressed companies. "Sponsors can minimize their exposure to these kinds of liabilities by being careful not to become directly involved in employee-related decisions, by hiring independent financial advisors to work with portfolio companies that become distressed, and by following best practices with respect to corporate separateness, fiduciary duties, documentation of management agreements, and similar formalities."

Eugene A. Boyle, a partner at Neal Gerber & Eisenberg, notes that this may be easier said than done. "Private equity firms do have to strike the right balance between managing and protecting their investments and allowing portfolio businesses to maintain an appropriate degree of autonomy in order to minimize exposure to WARN liability, but the more difficult question for investors is how to toe that line."

To avoid direct involvement in the operational activities of a portfolio company, Boyle says private equity firms must resist the temptation to usurp the decision-making authority of the subsidiary's management team when financial performance of a portfolio company begins to falter.

"The private equity firm should maintain normal board oversight and leave critical decisions, particularly with respect to plant closings and employee layoffs, to the management personnel of the portfolio business." ▣

In the Next Issue...

- *Special Report: Restructuring Depts. of National Accounting Firms*
- *Special Report: European Restructuring Practices of U.S. Law Firms*
- *Research Report: Who's Who in Synagro Technologies, Inc.*

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