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Trading Reserve-Based Energy Loans

By Julia Lu

What's Inside:

WHAT'S INSIDE

From the
Executive Director's Desk

THOMAS MORROW, CIRA
AIRA

Training, Training, Training— As I settle into my first year as Executive Director, I look back on what I see as AIRA's service to its members. The mission statement of AIRA is: to unite and support professionals providing business turnaround, restructuring and bankruptcy services; and develop, promote and maintain professional standards of practice, including a professional certification program. It is this second part of the mission that really sets AIRA apart in the restructuring community. We have a number of different vehicles for delivering outstanding training to financial advisors in the field of restructuring.

CIRA Program—Our primary certification is the Certified Insolvency and Restructuring Advisor. We have been offering the CIRA program since 1992 to recognize professionals that demonstrate a high level of competency through not only the completion of a course of study and examination but by providing evidence of comprehensive experience. Since inception of the program, over 1,700 professionals have completed the requirements and call themselves CIRA. It is by far the largest program of its kind for financial advisors in the restructuring world. If you have not yet qualified for the CIRA certificate I strongly urge you to start the process as soon as you are able.

CDBV Program—In 2004 we introduced the Certification in Distressed Business Valuation program to address the need for a professional designation to recognize those who were skilled and experienced in distressed business valuation work or expert valuation testimony in bankruptcy litigation. The CDBV is designed to provide specialized training and certification that is uniquely and specifically formulated for the performance of services encompassing valuation of underperforming assets, including distressed and especially companies in bankruptcy. The CDBV is a three-part program. Part 1 is a two-day class followed by a half day test. Parts 2 and 3 are three-day classes followed by a half-day exam. The CDBV program is offered less frequently than CIRA; however, there are some opportunities to place out of some of the requirements. CDBV Part 1 is waived if you are a CIRA, or CTP (offered by the Turnaround Management Association). CDBV Part 2 is waived for valuation professionals that hold any one of the following certifications: ASA-business valuation, CBA, CFA, CPA/ABV or CVA/AVA.

Self-Study Resources—To round out our offerings we have a library of self-study materials. These CPE eligible courses allow you to learn focused bankruptcy and reorganization subjects at your own pace. We currently have over 25 topics and are constantly adding new topics. Please go to our website (www.aira.org) to see the catalog. There are topics for every practitioner, from seasoned veteran to those new to the industry.

I hope you will find this range of educational materials useful in your career in the restructuring arena. I look forward to seeing you at one of our classes in the future.

A Letter from
AIRA's President

ANGELA SHORTALL, CIRA
AIRA President
Protiviti Inc.

I look forward to seeing many of you at two key events on AIRA's calendar for the last quarter of 2016. First is the **90th Annual National Conference of Bankruptcy Judges (NCBJ)**, October 26-29 in San Francisco. At NCBJ, AIRA will host two events – the Opening Reception on Wednesday, October 26, and AIRA's breakfast program on Friday, October 28. We are especially grateful for the support of our **2016 NCBJ Opening Reception Marketing Partners – *CBIZ, Conway MacKenzie, Deloitte, Ernst & Young, Huron*** and ***Protiviti*** – who join AIRA to host the Opening Reception, show appreciation to the Bankruptcy Judges, and welcome about 2,000 registrants to the conference. **AIRA's Breakfast Program on Friday – "Everything's Changed! What's Next in Bankruptcy Reporting Requirements?"** – will provide a detailed update on changes in reporting requirements. For this program we thank moderator Steve Darr, CIRA, CDBV *(Huron)* and panelists Guy Davis, CIRA, CDBV *(Protiviti)*, Nancy Peterman (*Greenberg Traurig)*, and Rob Charles (*Lewis Roca Rothgerber Christie LLP)*. Registration is open at www.aira.org.

Second is **AIRA's 15th Annual Advanced Restructuring and Plan of Reorganization Conference ("NY POR")** on Monday, November 14 at the Union League Club of New York. **Conference Co-chairs, Brian Ryniker, CIRA** *(CBIZ MHM, LLC)* **and Walter Greenhalgh** *(Duane Morris LLP)* and the 2016 Planning Committee have been hard at work developing an outstanding educational program including: 2016 – The Year in Review from Perspectives of Judges and Attorneys; When a Reorganization Derails: Alternatives and Landmines; Litigating Ponzi Schemes in Bankruptcy Cases; plus sessions on Brexit, the Retail Industry, and Intellectual Property Transactions. Sonia Colón, Esq. (Ferraiuoli LLC) will give a presentation on The Future of Puerto Rico during the luncheon. This year's **Judicial Service Award recipient, The Honorable Christopher S. Sontchi**, will be recognized at the evening reception. AIRA would like to thank the following 2016 NY POR sponsors for their support– ***AlixPartners, Arent Fox, CohnReznick, Duane Morris, Huron, Kaye Scholer, RSM US LLP, WeiserMazars,*** and ***Young Conaway Stargatt & Taylor***. For registration see www.aira.org.

In addition, it is not too soon to mark your calendar and start planning to attend **AIRA's 2017 Annual Conference ("AC17"),** June 7-10 at the Four Seasons Las Colinas in Dallas, Texas. Months of hard work are just beginning for **AC17 Co-chairs Walt Brown, CIRA** *(FTI Consulting)*; **David Payne, CIRA, CDBV** *(D.R. Payne & Associates)*; and **Ian Peck** *(Haynes & Boone)* as well as the planning committee. I am already looking forward to another outstanding conference experience, with an exciting educational program and fun networking/social activities to enjoy what Dallas ("the BIG D") has to offer. The Association would not be able to present this top quality program without the generous support of many sponsors. If your firm is interested in becoming an AC17 sponsor, contact me, the Co-chairs or Cheryl Campbell, AIRA's Conference Director, at ccampbell@aira.org.

Trading Reserve-Based Energy Loans

JULIA LU
Richards Kibbe & Orbe LLP

As debt issued by oil and gas exploration and production companies continues to trade at distressed levels, the secondary loan market has focused on the distinct lending structures developed to finance the exploration and production of energy in the United States. One such structure is "reserve-based financing," under which a lender's commitment to lend is based on the predicted future value of the borrower's oil and gas reserves that serve as collateral for the loan. The contractual method of determining the borrowing base and the nature of the collateral give rise to unique issues that need to be considered when parties trade loans and commitments of this type.

In today's volatile price environment for energy-related commodities, the borrowing bases for reserve-based revolvers – and therefore the amount of commitments available under these credit agreements – have declined dramatically with the price of oil. This decline and the diminished potential for future increases in borrowing bases affect the economic assumptions of parties who trade reserve-based revolvers in the secondary market.

This article provides a roadmap for market participants as they identify, analyze and value reserve-based energy loans and commitments.

BACKGROUND: HOW RESERVE-BASED FINANCING WORKS

Oil and gas exploration and production companies use different forms of financing for their project development, liquidity and working capital needs. Sub-investment grade companies often use loans primarily secured by the borrower's oil and gas reserves. In the U.S., the energy reserves that qualify as collateral for this type of financing are typically categorized as (i) proved, developed and producing, (ii) proved, developed and non-producing, or (iii) less frequently, proved and undeveloped. In international markets, other types of reserves (*e.g.*, probable reserves) may be used as collateral as well.

Reserve-based credit facilities are generally sized by reference to a "borrowing base amount," which is the aggregate forecasted value of the hydrocarbons in the reserves, calculated based on commodity price assumptions and discounted by a haircut applicable to the category of reserves. The borrowing base amount is redetermined periodically (generally twice a year, in spring and fall) to take into account changes in commodity prices as well as any depletion of existing reserves or acquisition of new reserves.

In the U.S. market, lenders may have substantial control over the art, as opposed to the science, of redetermining the borrowing base. This level of lender control differentiates reserve-based revolvers from traditional asset-based loans secured by receivables or manufactured inventory. During the borrowing base redetermination process, a decrease in the borrowing base amount typically requires the approval of lenders holding a majority of the commitments. An increase in the borrowing base amount on the other hand may require approval by a supermajority or all of the lenders. In non-US markets, individual lenders may not have approval rights over borrowing base redeterminations.

The substantial protection afforded to lenders in the redetermination process is typically restricted by certain limits and prerequisites. In order to challenge a borrowing base amount proposed by the borrower or the administrative agent (or another bank charged with the function), a lender may be required to propose its own borrowing base amount within a certain time frame, using customary (or otherwise prescribed) oil and gas lending criteria. The lender's silence may be deemed consent to the proposed borrowing base. The technical expertise required in the calculation and negotiation of the borrowing base may present an issue for non-bank lenders unfamiliar with arcane borrowing base calculations.

Borrowers can typically control the identity of the lenders who remain obligated to fund future drawdowns – if a lender sells its commitment to a third party, the borrower may have the right to consent before the third party can purchase the commitment by assignment. To the extent that the borrower does not consent, the lender may sell an economic participation in the commitment, but under the terms of the credit agreement the participant may be barred from influencing the redetermination process (unless the participant holds the entire position of the lender and can effectively direct the lender to take actions in connection with any redetermination). Obtaining a security interest in oil or gas reserves is complex, but relatively straightforward in the U.S. as compared to many other jurisdictions. In the U.S., mortgages can be taken over real property and mineral rights, and a security interest may be granted and perfected on reserves while they are still in the ground.[1] In the case of a producer bankruptcy in the U.S., the automatic stay under Chapter 11 would prohibit a counterparty under a lease or license from terminating the lease or license without leave of the court, thereby protecting the debtor and, indirectly, the interests of the lenders.[2]

SECONDARY LOAN TRADING CONVENTIONS IN THE U.S.

Over the past few decades, the secondary loan trading market has developed and matured in the U.S. and its main trade organization, The Loan Syndications and Trading Association (LSTA), has substantially standardized the trading terms and conventions. The brief summary of these terms and conventions below provides some contexts in which issues relating to trading reserve-based revolvers arise.

When a fully-funded loan trades at a rate lower than par, the purchase price that a purchaser would pay is the product of the purchase rate and the principal amount of the loan. When a commitment is only partially funded, however, the purchase price needs to reflect the obligation assumed by the purchaser to fund the commitment in the future. As a result, the purchaser would receive a credit towards the purchase price in an amount equal to the product of the principal amount of the unfunded commitment and the difference between par and the purchase rate. This convention ensures that if and when a purchaser funds a future drawdown on the commitment as a lender of record, it does so at the same purchase rate it would have had if the commitment were funded at the time of purchase. On the other hand, if the commitment is never drawn, then the purchaser would benefit from a "windfall" because it already received the credit from the seller in relation to the funding obligation. A purchaser of a loan usually takes the place of the seller as a lender of record after settlement of the transaction (the so-called "assignment") and enjoys important rights under the credit agreement, including votes to take actions or approve or disapprove amendments or waivers. If, however, such an action, amendment or waiver arises while a purchase is pending, market convention does not provide the purchaser with a contractual entitlement to exercise the voting rights under the credit agreement. Instead the seller may, and in practice usually does, give the purchaser an opportunity to express a preference, though the seller is not obligated to take the action preferred by the purchaser.

1 Sometimes this security interest might be affected by the alleged property rights of the borrower's counterparties under so-called "midstream contracts," under which the borrower dedicates its reserves to a midstream counterparty's gathering and pipeline system and covenants to produce a minimum volume of oil or gas from its fields, thereby ensuring the minimum utilization of the gathering and pipeline system. This controversial issue is the subject of ongoing litigation in the bankruptcy cases of *Sabine Oil & Gas Corp.* and *Quicksilver Resources Inc.* On March 8, 2016, Judge Chapman ruled in the *Sabine* case that the midstream contract counterparties do not have a property right and their contracts can be rejected by the debtor.

2 The laws of other jurisdictions are less clear and certainly not uniform. In emerging markets, in particular, government consent may be required in granting or enforcing security interest in the reserves because the right to explore for or extract hydrocarbons may require the grant of some form of license or concession from, or a production sharing agreement with, a governmental authority.

An assignment of loans and commitments typically requires the consent of the administrative agent under the credit agreement and, to the extent that commitments are assigned, consent of the borrower. Sometimes such consent is not forthcoming, necessitating a different transfer mechanism (the so-called "participation") for which the agent's and the borrower's consent is typically not required because the seller remains a lender of record to whom both the agent and the borrower would look for future exercise of rights and performance of obligations under the credit agreement. The seller would grant the participation to the purchaser, which typically gives the purchaser a contractual right to direct the seller to take, or refrain from taking, actions under the credit agreement.

Such contractual rights are always subject to the limitations under credit agreements, which often enumerate matters in which participants can (indirectly) have a say, while prohibiting lenders from voting in accordance with participants' directions with respect to other matters. A participant's voting rights are also limited by the fact that it may hold less than a majority of the seller's position in the loan. When the seller's vote under the credit agreement is not divisible, the vote would be controlled by holders of a majority of its lender-of-record position, calculated based on all participants holding a participation interest from the seller and the seller itself (to the extent the seller keeps beneficial ownership of a portion of its position). The seller, therefore, would not be obliged to comply with the directions of any participant that does not agree with the majority.

TRADING RESERVE-BASED REVOLVERS

Calculating Credit for the Unfunded Commitment

As outlined above, a purchaser receives a credit of the difference between par and the below-par purchase rate on any unfunded commitment that is "assumed by" the purchaser. In a declining oil price environment, it is likely that the current borrowing base amount, which is based on the forecasted future value of oil and gas reserves, is now substantially lower than the original commitment amount specified in the credit agreement, and may not soon revert to the maximum commitment levels negotiated when oil and gas traded at pre-crash levels.

As a result, the established pricing convention raises an immediate question for purchasers and sellers of reserve-based revolvers: should a purchaser receive a credit for the maximum commitment permitted under the credit agreement if there is little present prospect that future energy prices will allow a borrower to draw down on the maximum commitment? A seller is likely to argue that purchase price credit should be calculated based on the current (reduced) available and unfunded commitment amount because the borrowing base redetermination process is unlikely to allow the original commitment amount to be drawn. Since a purchaser only receives a credit for the unfunded commitment that it actually assumes, whether, and to what extent, a purchaser has control over future borrowing base increases under the credit agreement may

Continued from p.7

be important in determining the amount of the credit a purchaser should get for an unfunded commitment.

If a lender (*i.e.*, the purchaser who acquires the commitment by assignment) has an absolute right not to agree to fund an additional commitment based on an increase in the borrowing base amount, as is the case with some agreements in the U.S. reserve-based market, a seller may argue that the purchaser is only assuming the unfunded commitment calculated based on the existing borrowing base amount. On the other hand, as discussed above, a purchaser may respond that a lender's right to object to an increase in the borrowing base amount may not be absolute, and in any event the purchaser's vote may be insufficient to block an increase of the borrowing base amount. Under those circumstances, a purchaser may be forced to "assume" the unfunded commitment up to the original commitment amount.

This is a real economic issue, one which may result in a gap between the expectations of sellers and purchasers. Indeed, oil prices have begun to recover since the most recent redetermination in spring 2016, and there will likely be increases in borrowing bases in the next redetermination this fall. This experience may further inform the market as to the practical approaches parties should take in pricing of the unfunded commitments.

If the spread between the seller's offer and the purchaser's bid is too wide on the purchase price credit issue, parties may try to strike a risk-sharing compromise. For example, a seller may be willing to "co-fund" any future draw and agree to remain liable to contribute (at the rate of 100% minus the purchase rate) a portion of any future draw on the unfunded commitment in excess of availability based on the existing borrowing base amount. This way the seller can avoid giving an up-front credit to the purchaser and effectively pay that credit only if the available commitment is increased through the redetermination process and the additional commitment is drawn down. The downside, of course, is that the seller may not be able to de-recognize the commitment from its books, and may continue to take the credit risk of the purchaser.

Most importantly, identifying the effect that redetermination of the borrowing base may have on calculation of the purchase price before committing to a trade will allow a purchaser and a seller to ensure that they agree on the purchase price calculation. They may need to negotiate and possibly modify the standard trading terms to reflect a fair resolution of this important issue.

Controlling Redetermination as a Purchaser

At this stage of the commodities cycle, one of the most important rights of a lender is control over the redetermination of an energy producer's borrowing base amount. Therefore, a purchaser's due diligence should include a careful review of the credit agreement to understand the type of control a lender has over redeterminations.

Secondary market purchasers should also be aware that, under the trading conventions adopted by the LSTA, during the period from trade date to settlement date a purchaser does not technically have a right to vote (or otherwise participate or control the seller's participation in the redetermination process), although this right may be extended by the seller as a courtesy. If a redetermination is expected to occur between trade date and settlement date, a purchaser would be well advised to specifically require a right to direct the seller to act on the issue.

Controlling Redetermination as a Participant

Borrower's consent is usually required for transfers of commitments by assignment. If a distressed borrower is wary of accepting new (and possibly aggressive) lenders into the lending syndicate, a purchaser may need to acquire the debt by participation. A participant's vote, however, may be restricted under the credit agreement. For example, a credit agreement may permit a participant to vote only with respect to limited matters, which may not include redetermination of the borrowing base. Even if a participant can vote on redetermination matters, there could be practical limitations on the participant's vote, to the extent that the participant does not hold at least a majority of the lender's position in the loan, since a lender usually takes most, if not all, actions according to a majority vote of its participants, which majority could take into account the seller itself if it continues to own a portion of the loan.

The control issue is also a concern for sellers that grant participations, because they will continue to have obligations under the credit agreement as lenders. It is therefore in the seller's best interest to negotiate a voting (or consultation) regime that satisfies the seller's obligations under the credit agreement as a lender and, to the greatest extent possible, avoids and resolves conflicts with a participant in connection with redetermination issues.

Transferring Security Interest

Because the value of a reserve-based loan depends on the lending syndicate's security interest in the reserves, a purchaser of the loan will need to ensure that the security interest will be transferred with the loan and the priority of the security interest will be preserved. In the U.S. this is straightforward because a collateral agent typically holds the security interest on behalf of all current and future lenders. In a non-U.S. jurisdiction, however, transfer of the security interest could present issues. For example, governmental or third-party consents may be required for the transfer, and such consents may not be forthcoming. In addition, a transferee of the security interest may lose priority if it acquires the loan under a novation structure.

Maintaining Priority Status of Security Interest on Hedging Swaps

Lenders in the bank group may provide swap products for the borrower to hedge commodity price or interest rate risks. These swaps are typically secured on a *pari passu* basis with the loans under the credit agreement and therefore share the backing of the reserve-based collateral. When a lender sells its loan position, it should carefully analyze the impact of the sale on the priority status of its hedging swaps. If the seller no longer owns any loan position, any new swaps that the seller provides may not be secured under the credit agreement even though its existing swaps may continue to benefit from a *pari passu* security interest.

CONCLUSION

Reserve-based revolvers present unique challenges and opportunities for participants in the secondary trading market for energy loans. Parties should carefully consider how their economic assumptions will be affected by the borrowing base redetermination process and each party's ability to control that process. While the market's view on future changes in borrowing base amounts, largely determined by future commodity prices, will serve as a rational basis for any pricing model, each trading counterparty will need to ensure that their individual rights and obligations under their documentation will be consistent with that model. Modification or clarification of trading conventions and standard terms may be necessary to reallocate the risks, control, obligations and rights between parties to a secondary trade.

ABOUT THE AUTHOR

Julia Lu

Drawing on her background in securities offerings and her previous experience as the acting chief operating officer of a trading desk, Ms. Lu focuses her practice on distressed debt and derivatives markets. She advises clients in transactional and regulatory aspects of their trading businesses, and collaborates with them to formulate strategic, pragmatic legal solutions to complex trading and risk management issues. In her distressed debt trading and special situations practice, Ms. Lu collaborates with her clients – major broker-dealers and hedge funds – to formulate policies and procedures, and to structure and draft standard documentation. She also helps clients formulate strategic approaches to special situations trading and investment opportunities in the distressed markets. Previously, Ms. Lu was seconded to Goldman Sachs as COO of the bank loan trading and syndication desk.

Rough Market Terrain Hobbles Metals and Mining Sector

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AlixPartners, LLP

Companies in the metals and mining sector continue to battle major economic headwinds that have resulted in many high-profile Chapter 11 bankruptcy filings in the past two years—particularly in the coal subsector. But companies can improve their chances of surviving this prolonged stretch of distressed conditions and increase the likelihood of long-term viability by a decisive, targeted, and proactive focus on cash, cost structure, and debt management.

The numbers show that 2015 was an especially difficult year for the metals and mining sector, and 2016 is shaping up to be even tougher. The industry suffered the highest issuer-denominated default rate in 2015 (Figure 1), at 6.5%, with oil & gas a close second, at 6.3%. Metals and mining accounted for 14% of all defaults.[1] Arch Coal's Chapter 11 filing in January[2] continued the wave of distressed activity in 2016, marked most recently by Peabody Energy's filing in mid-April.[3] Those two follow large-scale 2015 filings by Alpha Natural Resources,[4] Walter Energy,[5] and Patriot Coal (its second filing since 2012),[6] as well as defaults by Berau Coal Energy[7] and Ferrexpo,[8] among others. Though the coal subsector was especially hard hit in 2015 and at the start of 2016, other metals and mining companies also began formal restructurings. They include US-based Molycorp (rare

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1 Moody's, "Corporate Default and Recovery Rates, 1920-2015," February 29, 2016.

2 Amey Stone, "Arch Coal Files for Bankruptcy; Coal Default Rate at 'Unprecedented' 43%," *Barron's*, January 11, 2016, http://blogs.barrons.com/incomeinvesting/2016/01/11/arch-coal-files-for-bankruptcy/.

3 John W. Miller and Matt Jarzemsky, "Peabody Energy Files for Chapter 11 Bankruptcy Protection," *Wall Street Journal*, April 14, 2016, http://www.wsj.com/articles/peabodyenergy-files-for-chapter-11-protection-from-creditors-1460533760.

4 Linda Sandler, Tim Loh, Jodi Xu Klein, and Laura J. Keller, "Coal Miner Alpha Natural Resources Files for Bankruptcy," Bloomberg News, August 3, 2015, http://www.bloomberg.com/news/articles/2015-08-03/coal-miner-alpha-natural-resources-files-for-bankruptcy.

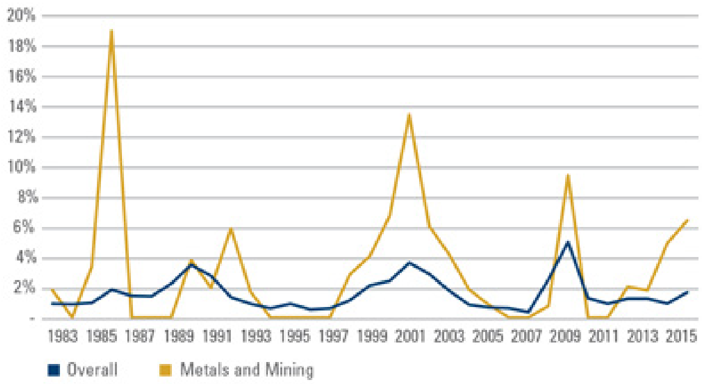
5 Matt Jarzemsky and Joseph Checkler, "Walter Energy Files for Bankruptcy Protection," *Wall Street Journal*, July 15, 2015, http://www.wsj.com/articles/walter-energy-files-forbankruptcy-protection-1436976576.

6 "Patriot Coal Files for Chapter 11—Again," *Financier Worldwide*, July 2015, http://www.financierworldwide.com/patriot-coal-files-for-chapter-11-again/#.VxBUF_krJD8.

7 "Berau Defaults on Its Senior Notes," *Jakarta Post*, July 11, 2015, http://www.thejakartapost.com/news/2015/07/11/berau-defaults-its-senior-notes.html.

8 Jesse Riseborough and Daryna Krasnolutska, "Ferrexpo Craters as $174 Million Held in Insolvent Bank," Bloomberg News, September 18, 2015, http://www.bloomberg.com/news/articles/2015-09-18/ferrexpo-slumps-after-saying-174-million-held-in-insolvent-bank.

FIGURE 1: US issuer-denominated default rates, 1983-2015



Source: Moodys

earths),[9] Magnetation (iron ore),[10] Canada-based Essar Steel Algoma,[11] and Noranda Aluminum.[12]

Prolonged Downturn Will Likely Continue

Metals and mining companies generally are capital-intensive businesses with high fixed operating costs. They typically have long histories that can mean high legacy costs, such as retiree benefits, union-related expenses, pension costs, and environmental obligations. Legacy costs represent a major reason the industry's default rate is outpacing the broader market's.

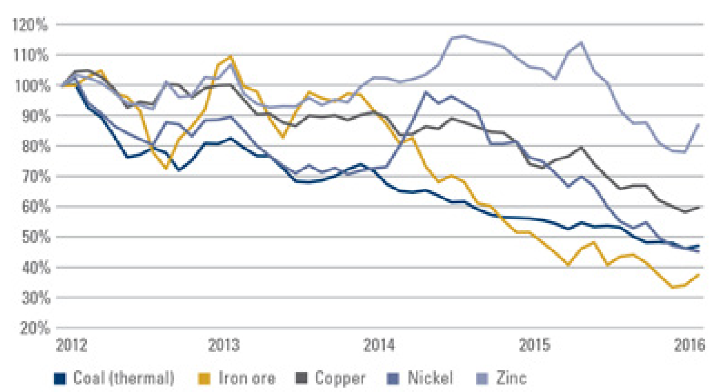
Most of the recent restructuring activity involves North American operations, but global factors affect the entire industry. Economic growth in China and high metals and commodities prices from 2010 to 2012 prompted many companies to invest in new production capacity, much of it financed through new debt.

China, which had been mining 95% of the world's rare earth minerals, in 2010 announced a 40% reduction in its own export quotas.[13] The announcement spurred a global wave of investment in rare earth mining capacity. Molycorp reopened its Mountain Pass mine in California, which had been idled since 2002,[14] and other rare earth miners in Australia and Malaysia expanded.[15] In the coal sector, historically high metallurgical coal prices encouraged new projects, including additional capacity in Australia[16]—primarily to serve the Asian metals markets.[17] In a specific example, Walter Energy—to increase its access to Pacific and Atlantic basin markets—in 2011 bought Western Coal, a metallurgical coal miner with operations in western Canada, West Virginia, and the United Kingdom.[18]

It takes time for metals and mining companies to create new capacity, as it does in most high-capital and high-fixed-cost businesses. When expansion happens, though, it happens on a large scale. By 2015, market conditions had already declined as most new capacity came on line, and due to slower Chinese and Brazilian economic growth, demand dropped as supply grew. The situation created two major effects: First, reduced investment in oil & gas exploration lowered demand for steel, which in turn reduced demand for metallurgical coal, iron ore, and other steelmaking components. During the past four years, steel prices have fallen by approximately 35%, from approximately $700 per metric ton in January 2012 to approximately $450 per ton in April 2016.[19] Second, lower oil & gas prices improved contribution margins for miners but also reduced the cost of substitutes for steel (aluminum and plastics) and steam coal (natural gas). That put further pressure on the demand for metals and coal and led to intense pricing pressure. Since 2012, thermal coal and iron ore prices have fallen by approximately 33% and 31%, respectively (Figure 2).

In this pricing environment, debt-heavy capital structures aren't sustainable in the long term, as was demonstrated by the recent spate of restructuring activity. Mining and production capacity takes time to create and tends to be sticky—and tough to cut back quickly when demand and prices fall. High fixed costs mean that contribution margins can remain positive even for higher-cost capacity, even if the enterprise operates at a loss. And because idling and

FIGURE 2: Selected ore pricing, 2012 to 2016 (January 2012 = 100)



Source: World Bank Commodity Outlook

9 John W. Miller and Anjie Zheng, "Molycorp Files for Bankruptcy Protection," *Wall Street Journal*, June 25, 2015, http://www.wsj.com/articles/SB10907564710791284872504581692703348728 48.

10 Tom Corrigan, "Magnetation Files for Chapter 11 Bankruptcy," *Wall Street Journal*, May 5, 2015, http://www.wsj.com/articles/magnetation-files-for-chapter-11-bankruptcy-1430841819.

11 Peg Brickley, "Essar Steel Algoma Files for Court Protection from Creditors," *Wall Street Journal*, November 10, 2015, http://www.wsj.com/articles/essar-steel-algoma-files-forcourt-protection-from-creditors-1447160540.

12 Shivam Srivastava, "Noranda Aluminum Files for Bankruptcy," Reuters, February 8, 2016, http://www.reuters.com/article/norandaaluminum-bankruptcy-idUSL3N15N1Z2.

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14 Danielle Venton, "Rare-Earth Mining Rises Again in United States," *Wired*, May 11, 2012, http://www.wired.com/2012/05/rare-earth-mining-rises-again.

15 Clint Jasper, "Staring Down a Multitude of Challenges, These Australian Rare Earth Miners Are Confident They Can Break into the Market," ABC.net, September 21, 2015, http://www.abc.net.au/news/2015-09-22/rare-earth-miners-face-tough-market/6786970.

16 Minerals Council of Australia, "Characteristics of the Australian Coal Industry," accessed May 9, 2016, http://www.minerals.org.au/resources/coal/characteristics_of_the_australian_coal_industry.html.

17 Mark Abernethy, "Commodity Industries Adapt to Lower Prices but Expanded Production," March 16, 2016, Australian Financial Review, http://www.afr.com/news/specialreports/resources/commodities-industries-adapting-to-life-with-lower-prices-but-expanded-production-20160313-gnhojc.

18 Walter Energy, Inc., Form 10-K, 2012.

19 "USA FOB Mill Price for Hot-Rolled Bands," SteelBenchmarker.com, accessed May 10, 2016, http://www.steelbenchmarker.com.

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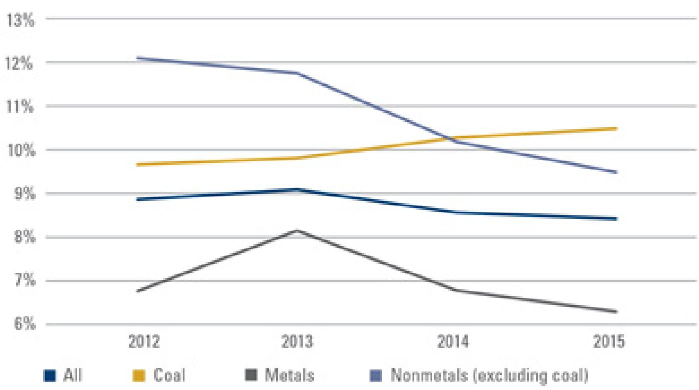
FIGURE 3: SG&A expenses as a percentage of revenue



Source: Capital IQ

retirement costs are high, operating at a cash loss may be more attractive than a more costly shutdown.

Reductions in overhead costs have barely kept pace with revenue declines—particularly in the coal sector. An AlixPartners analysis of 97 publicly traded metals and mining companies with annual revenues of at least $500 million showed minimal declines in selling, general, and administrative expenses (SG&A) as a percentage of revenue in the past four years (Figure 3). The average went from a median of 8.8% in 2012 to 8.4% in 2015. Revenues for these companies actually fell by a compound annual rate of minus 8.0% in the same period.

In the coal subsector, SG&A as a percentage of revenue actually increased from a median of 9.6% in 2012 to 10.5% in 2015, though revenue declines outpace the broader metals and mining sector by an average of minus 9.4% per year.

A Challenging Near-term Outlook

The shakeout for the sector will likely be protracted, with more balance sheet restructuring activity accompanying the industrywide recalibration of supply and demand. All signs point to continued elevated default levels for 2016.

Of the 97 companies analyzed, 57 (55%) had Altman Z-scores of less than 1.8, indicating high likelihood of filing for bankruptcy unless immediate and significant measures are taken. Another 20 (22%) had scores of 1.8 to 3.0, indicating some level of financial stress (Figure 4).

Within the coal subsector, the level of financial health is even lower, with 36 of 49 (73%) of the scores indicating distress and an additional 6 companies' scores (12%) indicating stress.

Operators Can Take Steps to Reduce the Stress

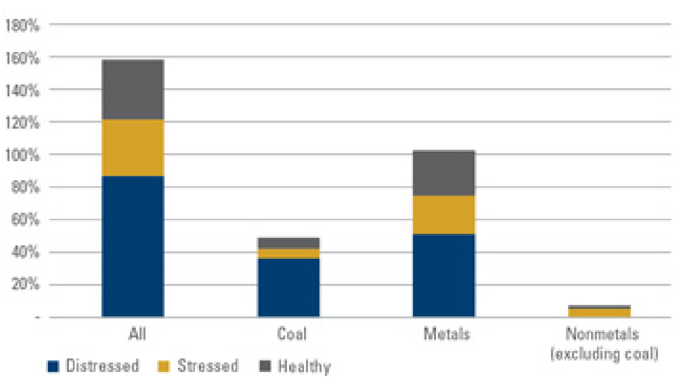
The roiling in the metals and mining sector shows little sign of abating. The sector is still plagued by a depressed pricing environment, lackluster economic growth in key markets, excess supply, and regulatory hurdles. For management and investors, the significant challenges are clear—and amplified by the asset-intensive, high-fixed-cost bases that companies need just to operate. Companies seeking to manage through the downturn need to take the following decisive steps.

Instill a cash-is-king mentality across the organization

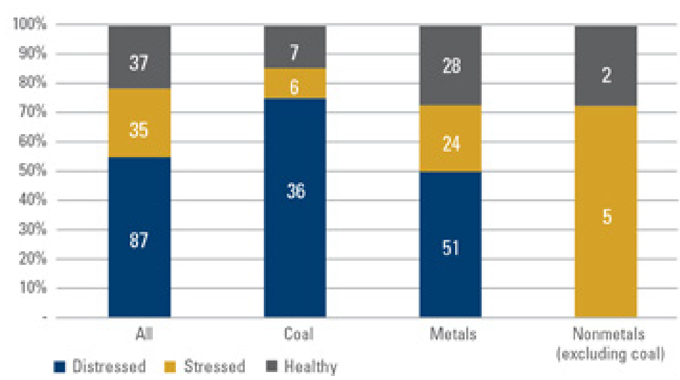
Low worldwide prices will likely increase pressure on companies to meet covenants and service commitments. Operators should make weekly cash forecasts, which would serve to offer much-needed ongoing visibility for cash needs and potential shortfalls. Such forecasts could give operators more time and more flexibility for taking measures that would improve liquidity, such as selling off excess inventory or fixed assets. The forecasts would also help develop a cash-focused culture. Simply *implementing* a forecast process would require an organization to focus on the timing of receipts and disbursements rather than on accounting events. And getting a detailed quarterly liquidity profile would spotlight cash generation measures and cash preservation alternatives that could include pulling receipts forward by offering selected customers onetime, early-pay discounts; or pushing disbursement timing outward, thereby completely eliminating uncommitted spending; or even changing the mine or mill's operating configuration. All of these measures can help preserve liquidity and maintain the broadest possible range of options.

Additional sources of cash often are found across the balance sheet. Working-capital management becomes more important, though in some organizations it takes a

FIGURE 4: Altman Z-score categorization by subsector by count and percentage



Source: Capital IQ and AlixPartners



Source: Capital IQ and AlixPartners

backseat to traditional profitability metrics. In a profit-and-loss-driven (P&L) world, selling excess inventory or fixed assets at low margins or below cost might be unthinkable. But when cash is king, managers find ways of developing creative solutions for marketing excess inventories or can find themselves willing to part with fixed assets they'd otherwise have kept for an eventual market upswing. Balance sheet review exercises also sometimes turn up opportunities that haven't been seriously considered before such as cashing in key-person insurance policies.

Drive cost reductions and operational efficiency

Minimizing costs and moving an organization down the cost curve during periods of rapidly declining prices is always daunting. It's even harder in an industry that has to shed excess production capacity. Cutting SG&A makes a start, but it's generally not a complete solution during a long-term downturn. Rigorous and continuous attention can help curb the staffing costs of direct and indirect labor. There may also be chances to renegotiate costs of supplies and services or find vendor consolidation opportunities. Considering different operating configurations may offer a clear view of potential cost levers that drive out inefficiencies, reduce unit costs, and preserve options for a time when industry conditions change.

We've witnessed a relatively high degree of vendor cooperation in pricing and payment terms as other supply chain participants recognize they, too, face the threat of financial distress in the current environment. So, potential changes to operating scenarios should be viewed on a cash basis rather than a P&L basis. For example, a decision to idle some or all production should consider the cash costs of idling versus any actual cash contribution rather than considering only P&L impact. Understanding breakeven price points and overall market supply and demand is critical, especially in determining when and under what conditions idled capacity might be turned back on.

Address capital structure issues early

A proactive focus on liquidity should also focus on other debt covenants. Companies can effectively use financial projections to identify which levels of pricing and cost scenarios could lead to possible covenant defaults and on what time horizon. Recent history shows that a severe downturn makes it much harder to refinance upcoming maturities, which often results in default. Successful management teams develop and pursue financing alternatives, and they plan for contingencies well before a default gets triggered. Engaging creditors and other constituencies such as bonding providers and state regulators might give a company more time and a wider set of options. Doing so can also dramatically improve the ability to reduce leverage and modify covenants.

Focusing on liquidity, cost structure, and capital structure can help buy time, and can ultimately position operators to thrive when the market improves; but to thrive in an upturn in the mining and metals sector, companies must first survive the downturn.

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Reorganization Value: What It Is…..and Isn't

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The importance of reorganization value is that it is perhaps *the* measure that determines whether a debtor will be able to reorganize, and the value of the reorganized debtor that is distributable to holders of interests and claims. Nevertheless, reorganization value is not specifically defined in the Code or in case law, other than by reference to the general principle that a debtor should be valued based on the capitalization of its expected future earnings. Bankruptcy courts must therefore determine the "extent and method of inquiry necessary for a valuation based on earning capacity….dependent on the facts of each case."[1]

Courts determine reorganization value *by reference* to the debtor's enterprise value based on the fair value standard, going concern premise, and present value of expected future cash flows and/or market multiples. Reorganization value is not the equivalent of enterprise value, however, though the terms are sometimes used interchangeably or confused with one another. Nor is it equal to the value of the firm, or to its equity. Only when each component of value is understood (*e.g.*, the cash flows included in a calculation, and how they differ), is it possible to intelligently analyze an investment or negotiate to maintain or enhance an interest or claim in a restructuring.

The Value of a Firm

Conceptually, a firm can be thought of as an assemblage of contracts. In this respect, the contracts a firm has with its owners are embodied in the corporate bylaws and stock certificates issued to its shareholders, who have a residual interest in the firm's assets in that they are entitled to the value of the firm that would remain if all other claims were paid. The value of a firm's assets must therefore be equal to the value of the claims on its assets, with the value of the firm being equal to the value of non-equity claims plus the value of equity.

1 *Consolidated Rock,* 312 U.S. at 527.

This principle is illustrated as follows from an accounting balance sheet perspective:

Assets = Liabilities + Equity

Assets are comprised of operating and non-operating assets, while liabilities combine operating liabilities and long-term interest-bearing debt. Consequently, the accounting balance sheet equation comingles operating liabilities and financing sources on the right side of the balance sheet:

Assets = Operating Liabilities + Debt + Equity

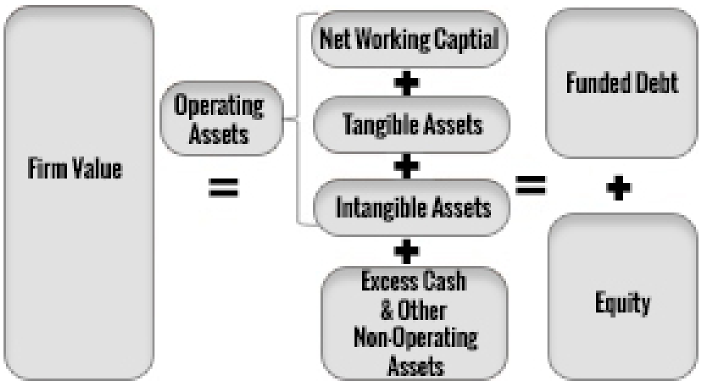
Rearranging the formula by moving operating liabilities to the left side of the equation leads to the measure of invested capital. The left side calculation shows how much capital has been deployed by the firm; the right side calculation shows how much financing has been provided by creditors and investors:

Assets – Operating Liabilities = Debt + Equity = Invested Capital

Exhibit 1 below illustrates these relationships in greater detail. Specifically, the value of the firm is shown to be equal to the value of its operating and non-operating assets, and to the value of its funded debt and equity. Operating assets include net working capital, tangible and intangible assets. Net working capital refers to *non-cash* operating working capital; for example, the net of trade accounts receivable, trade finance receivables, trade accounts payables, finance payables and accrued liabilities. Tangible assets include natural resources and fixed assets such as property, plant and equipment. Intangible assets (those that have value but cannot be seen or touched) include separately identifiable assets such as patents, copyrights, trademarks, brand names and customer contracts, as well as goodwill (that is, the residual that remains after the allocation of the purchase price of an acquisition to the fair values of the assets acquired and liabilities assumed).

A firm may also own assets that are not disclosed on its balance sheet or that are not used or essential to the core operations of the company. These types of assets are therefore classified as, and included in, non-operating

Exhibit 1



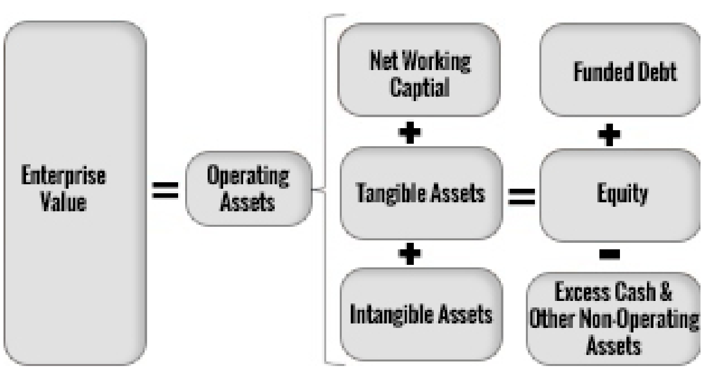
assets (also referred to as excess assets). Examples may include excess cash, marketable securities, loans receivable, unused buildings, unutilized equipment, vacant land and net pension assets.

Turning to the liabilities and capital side of the balance sheet, the claims on the value of the firm's assets include funded debt and equity. Equity is comprised of items such as common stock, preferred stock, options and warrants. Funded debt encompasses interest-bearing loans and financial obligations, such as bank debt, notes, bonds and off-balance sheet debt, which are not due within one year of the balance sheet date. As discussed above, non-interest bearing operating liabilities (typically current liabilities for operating expenses not paid during the period in which the expense was incurred, *i.e.* accounts payable) are not added to funded debt and equity. This is because non-interest bearing liabilities are implicitly netted out in valuing the firm as the financing charge implicit to purchasing a product or service on account is embedded in its cost.

Enterprise Value

Comparing Exhibit 1 above with Exhibit 2 below, it can be seen that as compared to firm value, which is equal to the value of the firm's operating and non-operating assets, and to the value of its funded debt and equity, enterprise value is equal to the value of the firm's operating assets, and to the value of its funded debt and equity less excess cash and other non-operating assets. As such, it is designed to measure the net price that an acquirer would pay to buy out investors and creditors after accessing the target's cash and marketable securities. Where a firm uses all of its assets in operations, the difference between firm value

Exhibit 2

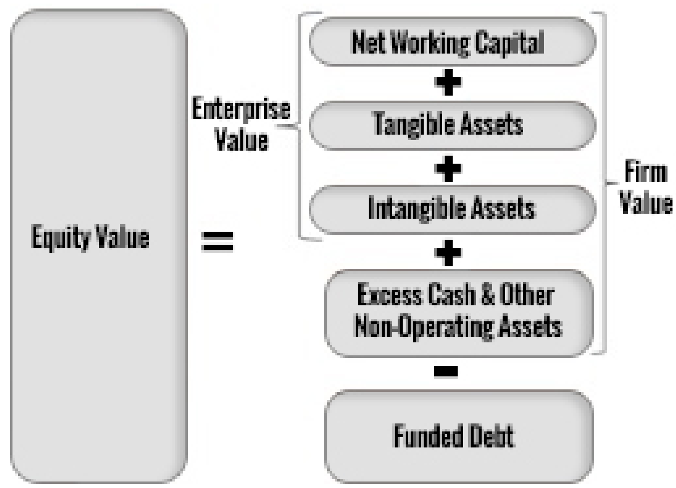


and enterprise value will be equal to the amount of cash *required* to support ongoing operations, if any.

Equity Value

Exhibit 3 below shows the calculation of equity value. Compared to the calculation of firm value shown in Exhibit 1, equity value is equal to the value of the firm, which consists of its operating assets, or enterprise value, plus excess cash and other non-operating assets, minus funded debt. In a reorganization, it is not uncommon for equity value to be negative and for the business to be insolvent from a fair value of assets versus liabilities perspective. At the same time, however, the ability of a *controlling* interest to direct the debtor's operations, its restructuring process, and to realize the surplus value in a successful restructuring is a material benefit having a positive value until such time as the interest is divested of its rights.

Exhibit 3



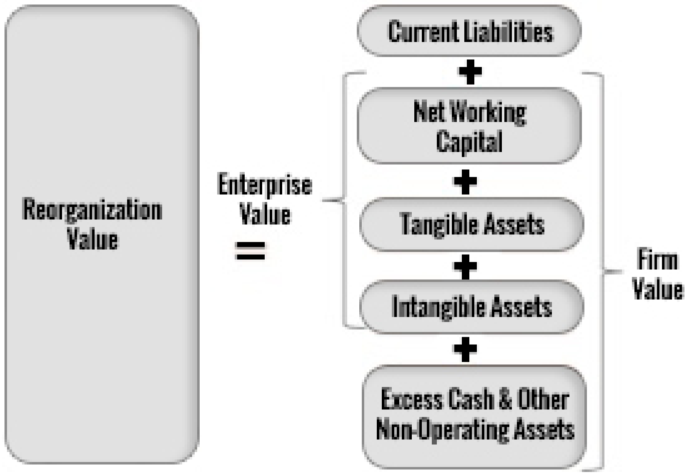
Reorganization Value

Reorganization value is the measure of the fair value of the firm that will emerge from bankruptcy as a going concern before liabilities are considered, and equivalently, of what a willing buyer would pay to acquire the firm's assets on emergence. It includes the value of the assets that will be attributed to the reorganized firm, plus that of other assets that may not be so attributed (*i.e.*, excess cash and proceeds from asset divestitures). The reorganization value of a firm is therefore equal to the value of the assets that are, or will be, available to satisfy post-petition claims and allowed interests, as determined in negotiations or litigation between the debtor-in-possession or trustee, creditors and equity interests. In this regard, the determination of reorganization value in a Chapter 11 proceeding differs from that in a capital market process due to the absence of a market for control of the firm's assets, lack of market oversight given management's access to debtor-in-possession financing, infrequent trading of the securities of bankrupt firms and limited coverage by analysts.

Exhibit 4 on the next page depicts the calculation of reorganization value. Comparing Exhibit 4 with the calculation of enterprise value shown in Exhibit 2, it is clear that enterprise value is not the equivalent of reorganization

Continued from p.15

Exhibit 4



value. Further, while enterprise value is a component of reorganization value, its value is necessarily less than reorganization value due to the inclusion in reorganization value of current liabilities (operating), excess cash and other non-operating assets, consistent with the definition that reorganization value is the measure of the fair value of the firm that will emerge from bankruptcy as a going concern before liabilities are considered. In the case of reorganization value, other non-operating assets also includes the cash proceeds from asset divestitures.

Free Cash Flow to the Firm v. Free Cash Flow to Equity

Generally speaking there two types of free cash flows: free cash flow to the firm and free cash flow to equity. Free cash flow to the firm ("FCFF") measures the cash flows distributable to all providers of capital, debt and equity, after all necessary investments, as if the firm were entirely financed with equity, ignoring taxes saved from the interest expense associated with debt. Free cash flow to equity ("FCFE") measures the cash flows distributable to common equity, after all necessary investments, and all payments to and from holders of non-equity securities.

Exhibit 5 below illustrates two of the ways in which FCFF and FCFE are calculated. The calculation of FCFF starts with net operating profit after-tax ("NOPAT"), also referred to as unlevered net income because the taxes deducted are the taxes the firm would pay if it had no interest deductions. To calculate gross cash flow, non-cash expenses or losses (herein, depreciation and amortization expense), are then added back to NOPAT, while non-cash revenues or gains are subtracted. To derive FCFF, capital expenditures and increases in working capital are in turn subtracted, while decreases in working capital are added back.

The calculation of FCFE begins with net income rather than NOPAT. Non-cash expenses and losses are subsequently added back, while increases in working capital and non-cash revenues and gains are subtracted. Next, cash flow from operations is reduced by capital expenditures, debt and preferred dividend payments, and increased by new debt issuances to arrive at FCFE.

From the foregoing it can be observed that the main difference between the calculations of FCFE and FCFF is that FCFE is net of payments to holders of non-equity claims such as preferred stock and debt. As already discussed, this is because common shareholders possess a residual interest in what remains of the value of the firm's assets after all other claims are paid. The choice of cash flow, like that of the value measure, must therefore coincide with the characteristics inherent to the measure of value and subject interest or claim.

For a firm with stable leverage, whether or not high, FCFE is preferable for measuring equity value directly rather than backing into it as a residual in the calculation of firm value (Exhibit 1) or of enterprise value (Exhibit 2). As with the practice of multiplying the number of a firm's outstanding shares by the corresponding share price to calculate an equity value, the equity value determined using FCFE should be adjusted to include the value of non-traded shares, stock options and shares from bonds or preferred stock that are convertible into common equity where applicable. Further, in choosing between the FCFE and dividend discount models, FCFE is better for firms that do not pay dividends, or that pay dividends that are significantly higher or lower than FCFE over an extended period of time. However, for firms such as banks and financial service firms where FCFE is difficult to estimate, or for firms that pay dividends and repurchase stock in amounts comparable to FCFE over time, the dividend discount model is a more desirable choice.

As for the FCFF model, like the FCFE model it is best for measuring firm value, enterprise value or reorganization value where that is the objective of the analysis. Notwithstanding, while the model is referred to as the FCFF model, if the cash flows relied on are cash flows that are expected to be generated by the firm's operating assets, the value measure derived will be the value of the firm's operating assets, or its enterprise value (Exhibit 2), and not firm value (Exhibit 1). Going from enterprise value to firm value will consequently require that the value of excess cash and other non-operating assets be added. Conversely, if the cash flows used in the FCFF model reflect the cash flow and income effects of the firm's excess cash and other non-operating assets (*i.e.*, cash, marketable securities, interest income, etc.), the resulting measure will be firm value rather than enterprise value absent elimination of these income effects (as a point of reference, the value of a firm's excess assets is embedded in its firm and equity values). Lastly, where the cash flows used to calculate reorganization value in part are attributable to the operating assets of the reconstituted debtor, the measure of value indicated by the FCFF model will be enterprise value, not firm value or reorganization value. Calculating reorganization value will require adding the values of excess assets, other non-operating assets and current operating liabilities (Exhibit 4).

Exhibit 5

Free Cash Flow to the Firm	**Free Cash Flow to Equity**
Revenue	Revenue
− Cost of Sales	− Cost of Sales
− Operating Expenses	− Operating Expenses
= Operating Income (EBIT)	= Operating Income (EBIT)
	− Interest Expense
	= Pretax Income
− Taxes on EBIT	− Income Taxes
= Net Operating Profit After Tax	**= Net Income**
+ Depreciation & Amortization	+ Depreciation & Amortization
	+/- Change in Working Capital
+/- Non-Cash Items	+/- Non-Cash Items
= Gross Cash Flow	**= Cash Flow From Operations**
+/- Change in Working Capital	− Capital Expenditures
− Capital Expenditures	+/- Change in Debt Principal
	− Preferred Dividends
= Free Cash Flow to the Firm	**= Free Cash Flow to Equity**

Key Takeaways

Reorganization value is determined *by reference* to the debtor's enterprise value based on the fair value standard. Reorganization value is not equal to enterprise value, however, or to the value of the firm or to its equity. Rather, reorganization value is the measure of the fair value of the firm that will emerge from bankruptcy as a going concern before liabilities are considered. Enterprise value is by comparison equal to the value of the firm's operating assets. So though enterprise value is a component of reorganization value, its value is necessarily less due to the inclusion in reorganization value of current operating liabilities, excess cash and other non-operating assets.

In general, there are two types of free cash flows: free cash flow to the firm, and free cash flow to equity. The main difference is that FCFE is net of payments to holders of non-equity claims given that the interest of common shareholders is equal to the residual of what remains of the value of the firm's assets after all other claims are paid. The choice of cash flow, like that of the value measure, must therefore coincide with the characteristics inherent to the measure of value and subject interest or claim.

The FCFF model is best suited to measuring firm value, enterprise value or reorganization value where that is the objective of the analysis. Where the cash flows used to calculate reorganization value are attributable to the operating assets of the reconstituted debtor, the measure of value indicated by the FCFF model will be enterprise value, not firm value or reorganization value. Calculating reorganization value will therefore require adding the value of excess assets, other non-operating assets and current operating liabilities.

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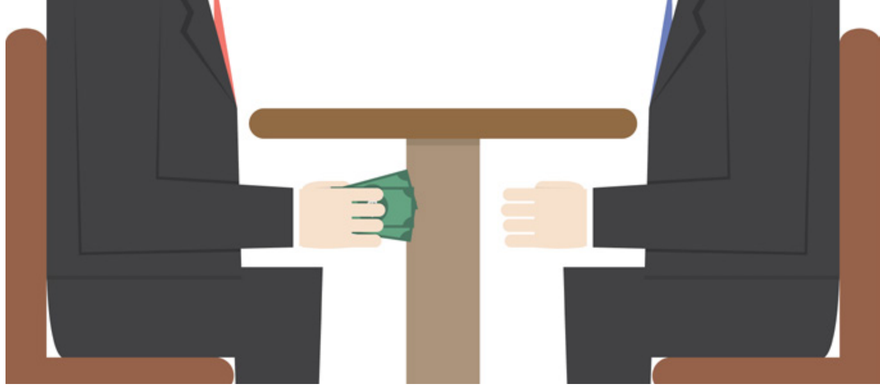
Anti-Bribery Management Systems: ISO's Proposed Standard



WILLIAM MARQUARDT AND DAVID HOLLEY
Berkeley Research Group, LLC

The International Organization for Standardization (ISO) recently released its draft standard (ISO/DIS 37001)[1] on Anti-bribery Management Systems, which is expected to be published in final form late in 2016. While the proposed standard adds to the collective body of information available to organizations to identify and implement measures designed to prevent, detect and address bribery, recent revelations at Unaoil[2] call into question the viability of any independent compliance program certification process. Similar to the continuing expectation gap surrounding the roles and responsibilities for detecting fraud in an organization, the expectations of the investing public regarding an independent anti-bribery certification are likely to be significantly misunderstood. Accordingly, the notion of independent certification should be reviewed in the context of the level of assurance possible, taking into account the associated costs and limited budgets available to corporate compliance and legal teams.

Notwithstanding the value proposition of an independent assessment and the review methodology supporting the certification, the draft ISO standard, while similar to the existing guidance, does not address the need to develop a set of overarching principles that will help an organization integrate the anti-bribery and anti-corruption ("ABC") management systems into the wider financial, operational and regulatory functions within an organization. To be effective, an ABC system must be deeply integrated into the operations of an organization while maintaining links to corporate governance, risk management and the management control environment.[3] The ability of senior management to articulate clearly how the compliance function operates and adds value to the organization is key to maintaining the credibility of the program when allegations of wrongdoing surface. Thus, the introduction of any new guidance provides an opportunity for an organization to evaluate and, if appropriate, benchmark its efforts against the latest thought leadership.

Background – Draft ISO 37001 Standard

The draft ISO 37001 standard is similar to the 2012 FCPA Resource Guide provided by the Criminal Division of the U.S. Department of Justice (DOJ) and the Enforcement Division of the U.S. Securities and Exchange Commission (SEC) in that it provides a list of management systems or elements of a management control system that an effective ABC program should contain. Similar to the DOJ/SEC guidance, the proposed ISO standard highlights the importance of management's own commitment to integrity and its involvement in developing and promoting an ethical corporate culture. The standard also requires a risk-based or proportionate approach to prevent, detect and address bribery and corruption that necessarily results in the existence of an appropriately tailored set of ABC compliance program components that, linked together, provide a cohesive ABC management system. With a few exceptions that will be highlighted herein, the program elements are very similar to available DOJ/SEC guidance.

Positive Contributions of the Draft ISO Standard

A review of the draft ISO standard reveals a number of benefits from implementing the enumerated ABC management systems and obtaining an independent, annual certification. Most significantly, implementing the ABC systems will allow an organization to assert that its anti-bribery program meets the basic standards of an "effective" ABC program. This could be used in support of management's assertion that should a bribe or corrupt activity occur it would be in direct violation of the company's ABC management systems and thus represent a "one-off" occurrence attributable to a "bad apple" employee(s). Additional benefits include, but are not limited to, the following:

- Provides a comprehensive focus on the existence of adequate ABC management program documentation,[4] document retention,[5] document protection, access, change management and the availability of information verifying the existence of risk assessments, oversight decisions, improvements, etc. Essentially, the maintenance of documentary evidence supporting senior management's assertion of "active involvement" in the creation and preservation of an effective ABC management program, or substantiating management's ethical "Tone at the Top."
- Promotes an inclusive view of stakeholders and the need to address both the voluntary (international participation/membership in anti-bribery organizations) and regulatory requirements to assert the existence of a functioning and effective ABC compliance program.
- Requires an annual review of the bribery risk assessment and evaluation process,[6] and requires the retention of documentation that demonstrates that an assessment has been conducted (*e.g.*, detailed evidence vs. notation or other summary statement) and its impact on the existing program (*e.g.*, continuous improvement).[7]

1 ISO 37001 - Anti-bribery Management Systems. Available at www.iso.org/iso/iso37001.

2 Richard Baker. "Unaoil and Trace: How the Ahsanis Fooled the World." Available at http://www.theage.com.au/interactive/2016/the-bribe-factory/day-2/trace.html; *and* The Unaoil Corruption Scandal: Where Was the Due Diligence? Posted April 6, 2016 at http://www.dnb.com/perspectives/corporate-compliance/unaoil-corruption-scandal.html

3 Committee of Sponsoring Organizations of the Treadway Commission (COSO). Enterprise Risk Management – The Framework. Available at http://coso.org/ERM-IntegratedFramework.htm

4 Line 1670 – section A.17 ISO/DIS 37001:2016(E).

5 Consistent or separate and apart from the normal document retention policies (protection of ABC program intellectual property).

6 The review process is defined as the systematic, independent, objective and documented audit of the anti-bribery program.

7 Line 433 – section 4.5.4 ISO/DIS 37001:2016(E).

Potential Pitfalls of the ISO Standard as Drafted

The biggest potential issue with the draft ISO standard and the accompanying certification may be a lack of clarity, which may be forthcoming, of what obtaining the certification will actually represent by way of assurances to an organization's stakeholders. Will validating the existence of ABC program elements—essentially confirming a "paper program" or a check-the-box evaluation—be sufficient assurance, or will the ISO's evaluation represent an examination of a company-specific, risk-based ABC compliance program inclusive of limited substantive testing; and, if so, at what cost to the organization? Companies will need to carefully examine the costs and benefits of obtaining the proposed certification as the draft standard transitions to a final version in late 2016. At present, issues with the proposed standard and certification include the following:

1. *Existence vs. operation* – In theory, when a company adopts the basic ABC management systems outlined in the ISO Standard for an ABC program, the organization has the opportunity to obtain an independent certification attesting that the program meets the standard of an "effective" ABC program, which is significantly different than the program being certified as operating effectively. Containing the appropriate components and verifying that the components are functioning as intended or are properly implemented based upon the company's unique risk profile may, as noted above, be beyond the scope of the evaluation. Using Trace International's reported pricing as a current benchmark (less than USD $5,000 for a certified report on corruption risks[8]), a thorough examination is unlikely, and the result may be some iteration of a "check-the-box" exercise, which offers little value to stakeholders.
2. *No sample organizational framework or minimum reporting structures are proposed* – Essentially, the draft ISO standard does not supply a framework or lens from which to evaluate or implement an ABC program, or to ensure that the five cornerstones of a strong governance framework are present: transparency, adaptability, evidence, resources and accountability.
3. *No new guidance or insights are provided in the current materials* – The ISO management systems standards present a reiteration of components of ABC guidance that already exist in multiple jurisdictions. Further, some of the guidance appears to reach beyond what is typically reasonable. For example, a lower threshold has been proposed for extending management's internal control system to outside third-parties—"more than a low risk" is a *very low threshold* when using either a three- or five-level risk assessment scale (*e.g.*, High/Medium/Low) to evaluate third parties. Existing vendor risk assessment processes are designed to effectively and efficiently identify and evaluate high-risk parties, which are often discussed in terms of normal distributions when evaluating organizations with tens of thousands of vendors operating in hundreds of jurisdictions. Further, discussions of direct or indirect control may have limited meaning in certain industries or operating locations.
4. *Periodic review and monitoring of ABC risk management systems are required, but no particular guidance is provided* – The draft includes neither examples of types of KPIs that would satisfy the continuous monitoring component nor discussion of activity and impact of KPIs.
5. *International labor and data privacy issues are ignored* – The standard is silent on labor and privacy considerations regarding employee cooperation and access to information required during the investigation of an allegation.
6. *Special issues for M&A and joint ventures are omitted* – There is no mention of the impact of business acquisitions, M&A or joint venture due diligence.
7. *The problem of cost v. benefit remains to be addressed* – The costs associated with adopting the standard as well as the annual review process may be substantial if the operation of the ABC system is evaluated. The standard refers to the need to understand each company's respective risk profile, which will be unique to the company and its operating environment. Additionally, any detailed testing of controls similar to Sarbanes-Oxley (Section 404) may prove prohibitively expense.

Conclusion

Defining the value of the draft ISO standard and the associated certification process will ultimately depend not on the existence of the selected ABC program elements, but rather on market and regulatory acceptance of the certification process. When considering the value of an independent certification, an evaluation of the expectation gap between what the certification represents and what the general public perceives it to represent should be a major consideration. Additionally, no certification will offer an affirmative defense for a violation of the U.S. Foreign Corrupt Practices Act or any other international act or regulation to an organization with an ABC compliance violation.

The views and opinions expressed in this article are those of the authors and do not necessarily reflect the opinions, position, or policy of Berkeley Research Group, LLC or its other employees and affiliates.

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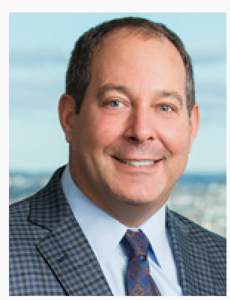

David A. Holley

Mr. Holley has more than 25 years of investigative and risk consulting experience. He frequently serves as a trusted advisor to corporations, law firms, financial institutions, audit committees, special committees of boards of directors, and their counsel. Mr. Holley's investigative expertise spans diverse areas including regulatory investigations; OFAC and sanctions compliance investigations and consulting; Bank Secrecy Act and anti-money laundering investigations; internal investigations involving fraud, employee, or third-party malfeasance, among others.

8 Adam Dobrik. "Trace President Defends Record in Wake of Unaoil Corruption Scandal." Posted April 4, 2016 at http://globalinvestigationsreview.com/article/1025507/trace-president-defends-record-in-wake-of-unaoil-corruption-scandal

AIRA@ NCBJ
90th Annual Conference, October 26-29, 2016
San Francisco Marriott Marquis

AIRA Hosts the NCBJ Opening Reception
Wednesday, October 26 from 5:30-7:30 PM

AIRA, along with our Marketing Partners, hosts this event to show appreciation for the Bankruptcy Judges and welcome everyone to the largest conference for the restructuring and turnaround industry. More than 2,000 attendees are expected and all registrants are invited to the Opening Reception. Additional Marketing Partner spots are available; for more information contact Cheryl Campbell at ccampbell@aira.org.

AIRA Breakfast Program
Friday, October 28, 7:30-8:45 AM

"Everything's Changed! What's Next in Bankruptcy Reporting Requirements?"

This educational presentation on recent, as well as anticipated, changes in bankruptcy reporting requirements is presented by Stephen B. Darr, CIRA, CDBV, Moderator (Huron); Robert Charles, Jr., Esq. (Lewis Roca Rothgerber Christie LLP); Guy Davis, CIRA, CDBV (Protiviti); and Nancy Peterman, Esq. (Greenberg Traurig, LLP). The panel will cover the following topics, among others:

- the completely revised Statement of Financial Affairs and Schedules of Assets and Liabilities and use of statement questions requiring more open-ended responses (effective December 1, 2015 pursuant to Rule 9009)
- draft of the new uniform Monthly Operating Reports proposed by the Office of the United States Trustee
- fee guidelines for attorneys and proposed fee guidelines for financial advisors in larger Chapter 11 cases.

Register Now for the Breakfast Program at www.aira.org

Find out more about 90th Annual NCBJ at www.ncbjmeeting.org

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Break Through the Barrage of Data with eDiscovery

VINCENZO TOPPI AND YANN GERON
CohnReznick and Fox Rothschild LLP

The lights are out, papers are strewn, all of the workstation computers are locked, and everyone is gone. If you are a bankruptcy trustee, you know this scenario all too well. With institutional knowledge of the company out the door; disparate, unconnected computer systems indecipherable and locked; and creditors demanding quick action, the life of a trustee isn't easy. To further complicate matters, the trustee is expected to build a comprehensive data set while maintaining a pristine chain of custody for litigation, which could well ensue.

Advances in eDiscovery – the process by which electronic data is sought, gathered, and secured to use as evidence in a civil or criminal legal case – are a breath of fresh air for the trustee. Not only can data integrity be maintained more easily, but with only 22% of the data typically found to be useful,[1] eDiscovery can build massive efficiency in finding the data the trustee needs, when the trustee needs it.

Expanding Data Universe Poses Increasing Challenge to Trustees

The growing magnitude of electronically stored information (ESI) makes building and implementing an eDiscovery protocol even more vital. The number of electronic data sources, ranging from webmail to mobile devices to social platforms and cloud apps, is rising exponentially. According to a 2014 EMC Digital Universe study, data produced by an organization continues to grow at an annual rate of 40%.[2] This ever-expanding data universe presents concerns for bankruptcy trustees. The trustee is charged with finding, isolating, and maintaining a massive amount of pristine data in order to effectively administer the estate, which entails managing accounts receivable collections and inventory liquidations, as well as notifying creditors and identifying assets. If future litigation is anticipated, the trustee must take the necessary steps to safeguard the data and preserve an unaltered copy to be used as the litigation proceeds. Unfortunately, in some cases, the likelihood of litigation isn't known at the onset of the case. Best practices indicate that a copy of the data should be preserved by the trustee in order to avoid spoliation issues down the road.

In most cases, the bankruptcy trustee is in a stress management situation. It is very difficult to discover where all of the data lies and there typically is no easy access to the passwords or to the organization's data map. Gaining access to critical data then relies upon identifying key people – and this is not typically senior management. It is the people at the desk who know the mapping system, have the passcodes and know how to gain access to the data. Locating these individuals can be extremely difficult – they often simply walk away because they are not getting paid. The trustee must understand what legal tools are available to the trustee and be able to identify who holds the "keys to the kingdom."

There are many other challenges facing bankruptcy trustees as they step into situations where management has vacated the company's premises, servers are running, and data is in disarray. Data is often stored in a multitude of disparate sources and in formats that are unusable. In addition, it can be difficult to even know where the information may be housed. For example, social media platforms may contain a significant amount of correspondence with employees and customers; or, a trustee might walk into an organization and not see any files on the desktop because the files are all stored on the web. It is crucial to determine who has access to the data and be prepared to utilize the latest eDiscovery tools in order to effectively and efficiently build a case.

Building a Robust eDiscovery Program

As a trustee winds down the operations of the business, they need to manage data and ensure correct information is available to financial advisors and any other parties that may require access. Without advanced data mining and eDiscovery technologies, however, this task can be arduous. If a trustee is not using the correct query system, the data can be overwhelming. In some cases years' worth of work-in-process (WIP) is not readily detectible within the accounting data. Accessing this information requires strategies such as tapping into the organization's e-mail system and analyzing the exchange of information to uncover the hidden work-in-process.

In situations such as this, forensic tools exist to index the vast amount of e-mail messages in a company's system and organize data so that trustees can rapidly access relevant information at the moment they need it. Such tools have the capacity to sort through copious e-mail threads and

1 The digital universe of opportunities: Rich data and the increasing value of internet things (April 2014). Available at http://www.emc.com/leadership/digital-universe/2014iview/index.htm

2 *Ibid.*

eliminate duplicative data. This includes tracking e-mail attachments as well as documents that exist within Microsoft Office and similar programs.

Personally Identifiable Information (PII) held by the debtor often becomes another significant area of concern for bankruptcy trustees relative to managing data, since the trustee, now a gatekeeper, will need to take steps to avoid inadvertent disclosure of any of the PII. While what constitutes PII varies by jurisdiction, PII typically consists of sensitive and personal information such as social security numbers, driver's license, taxpayer identification numbers, financial account numbers or credit card numbers, personal health information (PHI), and the like. Any organization with vendor and customer files possesses PII, and bankruptcy trustees must have a complete understanding of the volume of PII held by the debtor so that such sensitive information can be managed properly. Advanced data management systems allow the trustee and their professionals to identify all the PII in the organization's systems, isolate it and protecting it from inadvertent disclosure.

Conclusion

Electronic data is changing at a rapid pace: from the source of the data, to its use, to its sheer volume. A bankruptcy trustee must be prepared to act quickly and efficiently to face data challenges and understand that each case is unique and not without its particular requirements. Trustees must become well versed in best practices on how to overcome data challenges. Guidance from financial advisors and eDiscovery professionals who are attuned to the nuances involved in the process can be a tremendous advantage. From day one, the authors recommend bankruptcy trustees take reasonable steps to make a complete forensic image of the data. Trustees should assure that the information is retained and preserved, and then shut everything down. Taking this approach will enable the trustee to have the information from the onset and minimize and control data costs going forward. This will give a trustee the leeway to figure out the data they have in their possession, what they need to do with it, and what their net plus or minus is at the end of the day.

For more information on how bankruptcy trustees can take advantage of the growing advances in eDiscovery, contact Vinni Toppi, Director, CohnReznick Advisory's Restructuring and Litigation Practice, at 732-635-3129 or Vincenzo.toppi@cohnreznick.com, or Yann Geron, partner, Financial Restructuring & Bankruptcy, Fox Rothschild LLP, at 212-878-7901 or ygeron@foxrothschild.com.

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Yann Geron is co-chair of the Financial Restructuring & Bankruptcy Department at Fox Rothschild LLP, a national firm with 750 attorneys in 22 offices. He represents a wide variety of clients and interests in bankruptcies and out-of-court restructurings. Yann also has a robust trustee practice with significant experience in complex wind-downs and liquidations, and in the investigation and recovery of estate claims. He has served as a trustee in Manhattan in thousands of bankruptcy cases.

Bankruptcy Taxes

Abandoning a Partnership Interest to Avoid Cancelation of Debt Income

DAVID STERLING, SECTION EDITOR
RSM US LLP

A financially troubled partnership or limited liability company taxed as a partnership may recognize cancelation of debt income ("CODI") when it satisfies its debt for an amount of money or property which is less than the debt's face value. An individual partner of a partnership which recognizes CODI may receive an allocation of CODI which will be taxed as ordinary income at a top federal income tax rate of 39.6% at a time when the partnership may not be able to pay a tax distribution.

The partner receiving an allocation of CODI may have passive loss, at-risk loss, or net operating loss carryforwards which could offset any allocation of CODI. If the partner does not have any of these income tax carryovers, the partner may have to pay income taxes on his allocation of CODI. However, a partner may be able to avoid an allocation of CODI by abandoning his partnership interest before CODI is recognized by the partnership.

Abandonment of a Partnership Interest

To establish the abandonment of a partnership interest, a taxpayer must show an "intent to abandon" the interest and, must "overtly act to abandon" the interest.[1] In Revenue Ruling 93-80, a taxpayer's delivery of a written notice of abandonment to a partnership was recognized as evidence of an abandonment. In this ruling the partnership agreement was also amended to indicate that the abandoning partner was no longer a partner.

Under Section 706(c)(2)(A),[2] the taxable year of the partnership closes with respect to a partner upon the abandonment of his partnership interest. To avoid an allocation of CODI a taxpayer should abandon his partnership interest before the partnership recognizes CODI.

1 Revenue Ruling 93-80, 1993-2 C.B. 239.
2 Unless otherwise noted, all references to Code sections pertain to the Internal Revenue Code (26 U.S.C.).

Income Tax Consequences of Abandoning Partnership Interest

Any transaction in which a partner receives an actual or deemed distribution of money in liquidation of a partnership interest will result in the recognition of a gain or loss under Section 731. A deemed distribution of money occurs when a partner abandons a partnership interest to the extent the partner is relieved of the partner's share of partnership liabilities under Section 752(b). Gain is recognized under Section 731(a)(1) to the extent that money distributed, or deemed distributed, exceeds the adjusted basis of a partner's interest in the partnership immediately before the distribution. Section 731(a)(2) provides that loss is recognized by a partner only upon a distribution in liquidation of an interest in a partnership, where no property other than money, unrealized receivables and inventory is distributed to the partner. Any gain or loss recognized under Section 731(a) is considered a gain or loss from the sale or exchange of a partnership interest. Section 741 provides that gain or loss recognized on the sale or exchange of a partnership interest is considered a capital gain or loss except as provided in Section 751. However, "a loss from the abandonment or worthlessness of a partnership interest will be ordinary if there is neither an actual nor a deemed distribution to the partner." [3]

A partner who abandons a partnership interest will recognize an ordinary gain or loss from the deemed sale or exchange of Section 751 property to the extent that any actual or deemed distribution of money is treated as a sale or exchange of the partner's share of the partnership's Section 751 property. [4]

Section 751 property includes unrealized receivables and substantially appreciated inventory items. Unrealized receivables include receivables that have not been included in gross income under the partnership's method of accounting (*e.g.*, the cash method of accounting). Unrealized receivables also include certain property to the extent that ordinary income would be recognized upon its sale (*e.g.*, Section 1245 depreciation recapture from the sale of property and equipment). Section 751(b)(3)(A) defines substantially appreciated inventory items as inventory items which have a fair market value which exceeds 120 % of their adjusted basis. Section 751(d) defines "inventory items" as:

3 Revenue Ruling 93-80, 1993-2 C.B. 239.
4 Regulation Section 1.751-1(b)(3)(i).

- property of the partnership of the kind described in Section 1221(a)(1);

- any other property of the partnership which, on sale or exchange by the partnership, would be considered property other than a capital asset and other than property described in Section 1231; and

- any other property held by the partnership which, if held by the selling or distributee partner, would be considered an inventory item.

The abandonment of a partnership interest may generate a capital gain if the partner's share of liabilities exceeds his basis in the partnership, which is often the case if a partnership is insolvent. In this situation, a withdrawing individual partner may avoid the recognition of CODI which will be taxed at a top federal income tax rate of 39.6% and replace it with a capital gain taxed at a top federal income tax rate of 20%.

Basis Adjustments to Partnership Property

If a partner abandons a partnership interest before CODI is recognized, CODI will be allocated to the remaining partners who did not abandon their partnership interests (the "remaining partners"). In many instances, the partnership's assets are sold at a loss to provide funds to pay the partnership's debt. If a partnership's assets are sold at a loss after a partner abandons his partnership interest, the additional CODI recognized by the remaining partners may be offset by an increase in the ordinary loss recognized from the sale of the partnership's business assets. In this situation, there may be no tax detriment to the remaining partners from the withdrawal of the partner.

This increased ordinary loss from the sale of the partnership's business assets would come from the increase in the basis of the partnership's assets under Section 734(b) for gains recognized under Section 731(a)(1) by abandoning partners, if the partnership makes, or has previously made, a Section 754 election to adjust the basis of partnership property.[5] The partnership will also increase the basis of its business assets under Section 751(b) for income treated as ordinary income under Section 751.

These basis adjustments will normally increase ordinary losses from the sale of business assets because losses recognized from the sale of depreciable and real property used in a trade or business and held for more than one year are ordinary losses under Section 1231. Losses from the sale of inventory are also treated as ordinary losses because inventory is not treated as a capital asset under Section 1221(a)(1).

Conclusion

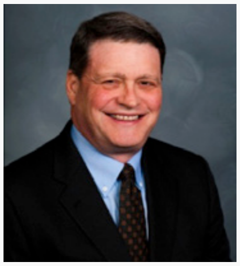
A partner who wishes to avoid an allocation of ordinary CODI should consider abandoning his partnership interest before the partnership recognizes CODI. A partner can abandon his partnership interest by issuing a written notice of abandonment to the partnership. The partnership should acknowledge this abandonment by amending its partnership agreement to indicate that the abandoning partner is no longer a partner.

The abandonment of a partner's interest in an insolvent partnership may generate a capital gain if the partner's share of liabilities exceeds his basis in the partnership. In this situation, a withdrawing individual partner may avoid the recognition of CODI and replace it with a capital gain taxed at a lower income tax rate.

If a partner abandons a partnership interest before CODI is recognized, CODI will be allocated to the remaining partners. However, there may be no tax detriment to the remaining partners if all of the partnership's assets are sold at a loss to provide funds to pay the partnership's debt after a partner abandons his partnership interest. In this situation, the increase in ordinary CODI recognized by the remaining partners may be offset by an increase in the ordinary loss recognized from the sale of the partnership's business assets after the basis of the partnership's assets are adjusted under Section 734(b) and Section 751(b) for any gains and ordinary income recognized by the withdrawing partner on the abandonment of his partnership interest.

5 The step-up in basis would be available if the abandoning partner recognized gain (as opposed to loss) on his withdrawal from the partnership.

ABOUT THE AUTHOR



David Sterling

David Sterling is the National Leader of RSM's Mergers and Acquisitions Tax Practice and has more than 30 years of experience advising multinational corporations, privately held businesses, publicly held corporations, and private equity firms on federal tax issues related to consolidated returns, C corporations, S corporations, partnerships, cooperatives, accounting for income taxes, and mergers, acquisitions and dispositions. Over his career, he has worked with companies in the manufacturing, retail and distribution, life sciences, technology, and professional services industries. David's client service focus at RSM is on advising clients on the federal tax consequences of mergers, acquisitions and dispositions, including tax structuring and tax modeling, tax due diligence, transaction cost deductibility analysis, change in control attribute analysis, bankruptcy tax analysis and structuring, debt restructuring, and stock basis and earnings and profits studies.

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