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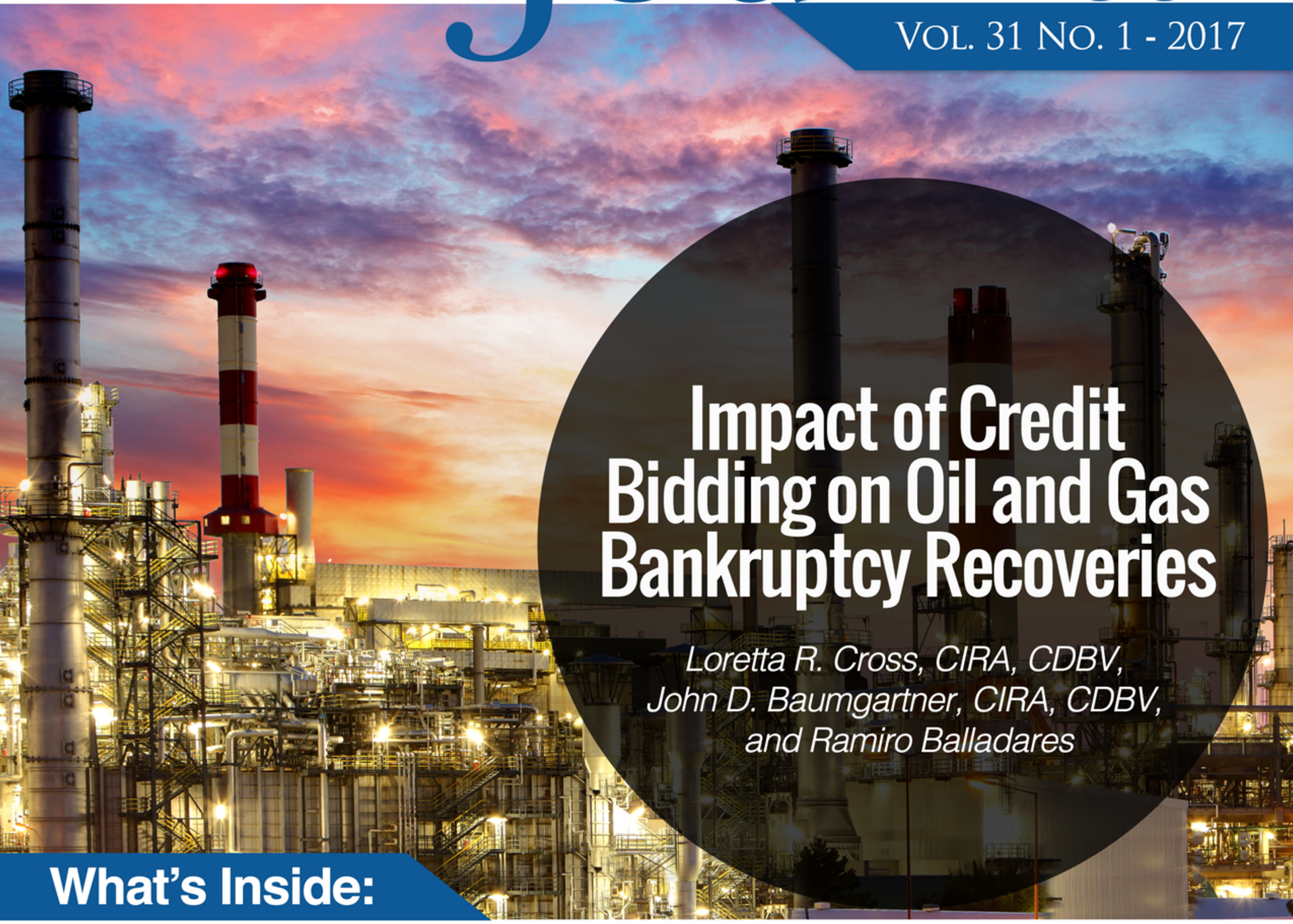

Impact of Credit Bidding on Oil and Gas Bankruptcy Recoveries

Loretta R. Cross, CIRA, CDBV, John D. Baumgartner, CIRA, CDBV, and Ramiro Balladares

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FROM THE ASSOCIATION

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From the
Executive Director's Desk

THOMAS MORROW, CIRA
AIRA

Dear AIRA Members,

I am writing my column for the AIRA Journal as we wrap up the annual two day meeting of the board of directors. I am also looking back over my first year as Executive Director of AIRA.

The AIRA is fortunate to have an enthusiastic, knowledgeable and active board. They have provided me the guidance I needed to get through my first year as Executive Director. The board members and their firms are some of the strongest supporters of the CIRA and CDBV program. They encourage their new colleagues to sign up and start the educational process toward certification. The board members also enthusiastically support all of AIRA's educational programs through generous sponsorship. Many of the board members also take leadership roles each year and organize the excellent educational programs we put on each year. Without their support and involvement the AIRA would not be the strong organization we know of today.

We have been fortunate to have Angela Shortall from Protivity as our President during this transition year. Angela was pressed into office early as I had to resign my position as President when I became Executive Director. Angela will lead us through the Annual Conference in Dallas before she turns the reins over to Joel Waite of Young Conaway Stargatt and Taylor at the end of the Annual Conference. At our board meeting the board unanimously agreed to have Kevin Clancy, CIRA of CohnReznick LLP become the President elect when Joel moves up.

During 2016 I was very happy to see many new faces taking the CIRA class. Many of the larger firms have increased their hiring in response to increased restructuring activity. These firms look to the CIRA program to provide a basic education to their staff of the bankruptcy system and restructuring.

And while activity started to pick up in 2016 it looks like it will continue into 2017 and potentially broaden in scope. 2016 was very busy for firms providing services to the E&P Energy firms that restructured in response to the continued low price of oil. Industry veterans that I talk with are looking to 2017 to be as busy, or many think, busier than 2016. Also, the activity seems to be spreading beyond the oil field. While there still seems to be work in the oil sector, particularly with service providers other industries seem to be ready for restructuring help. January always brings activity to retailers that had difficult holiday seasons. Brick and mortar retailers continue to struggle to compete with internet retailers and are facing strong restructuring headwinds. Healthcare continues to struggle to adapt to the Affordable Care Act and will likely face more challenges if President Elect Trump and the Republican-led congress follow through in making changes to the ACA. Restaurants, Commercial Real Estate and Shipping all look to be challenging segments that should provide plenty of business to Restructuring professionals.

I am looking forward to an active 2017 in my second year as Executive Director. I hope to see many of you in the year to come, either at a CIRA or CDBV class or at one of our education conferences.

A Letter from
AIRA's President

ANGELA SHORTALL, CIRA
Protiviti Inc.

Dear AIRA Members,

I am writing to you as we wrap up the planning for our 33rd Annual Conference ("AC17") and open the website for registration (http://www.aira.org/AC17). I am very excited about this year's program and want to invite everyone to join us in Dallas, June 7-10 at the beautiful Four Seasons Resort and Club Dallas at Las Colinas. On behalf of AIRA's Board of Directors, I want to thank the planning committee and conference co-chairs, Walt Brown, CIRA, David Payne, CIRA, CDBV, Ian Peck, and Judges Stacey Jernigan and Mark Mullin, for all of their hard work developing the conference.

The Annual Conference offers a tremendous value for continuing education. AC17 offers up to 23 CPE and 16.75 CLE credits for both the preconference and conference. On Wednesday two concurrent preconference programs are offered – one focusing on bankruptcy taxation and the other, Financial Advisors' Toolbox, on avoidance actions and recoveries. The Annual Conference begins on Thursday and features educational sessions on a variety of topics, including: Fossil Fuel Industry Update, Health Care, Higher Education, International Insolvency, Transportation, Hot Topics in Fraud, Heavy Metal, Industries to Watch, Trends in Financing, Structured Dismissals, Structuring Pre-Bankruptcy Transactions, Green Energy, Managing the Courtroom, Municipal Restructurings, Next Generation Technology, and The Ethics of a Troubled Company. Surely something for everyone!

We also have an exciting slate of keynote speakers. Clifford J. White III, Director of the Executive Office of the United States Trustee Program, will speak to us at lunch on Wednesday. Thursday morning kicks off with a presentation by Richard E. Taylor Jr., acting U.S. Marshall for the Northern District of Texas, and at lunch on Friday we will hear from Sarah R. Saldaña, Former Director, U.S. Immigrations and Customs Enforcement, U.S. Department of Homeland Security.

And what conference would be complete without some great networking and social events? Thursday afternoon offers a variety of optional excursions – Golf at the world famous TPC golf course at the Four Seasons, luxury treatments at the Well & Being Spa, Skeet Shooting and lunch at Gas Monkey Bar & Grill, and a self-guided tour of the George W. Bush Presidential Library and Museum, with lunch at Café 43. Thursday evening is our traditional Annual Banquet, where we honor the winners of the Zolfo Cooper awards for the highest scores on the CIRA exam, and present the annual Manny Katten Award, followed by a dessert reception. Friday night offers a true Texas experience with dinner and line dancing instruction at Austin Ranch, one of the oldest ranches in Texas.

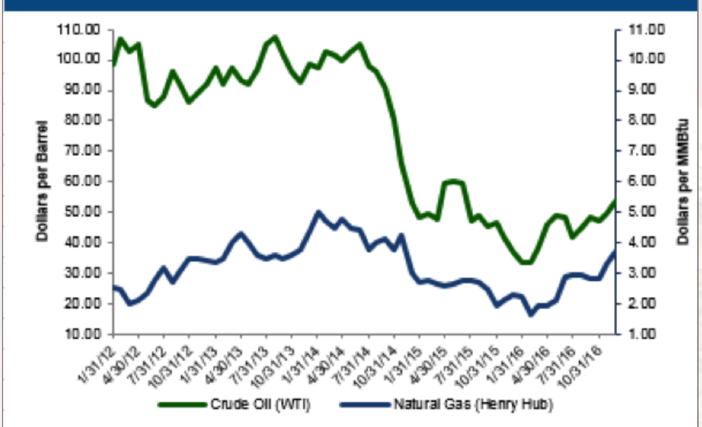
Don't miss the opportunity to improve your professional skills and make new friends at AC17. See you in Dallas!

Impact of Credit Bidding on Oil and Gas Bankruptcy Recoveries

LORETTA R. CROSS, CIRA, CDBV, JOHN D. BAUMGARTNER, CIRA, CDBV, AND RAMIRO BALLADARES
Stout Risius Ross

In 2014, the authors reported on credit bidding during oil and gas bankruptcies in an article titled, "How Credit Bidding is Impacting Oil and Gas Bankruptcy Recoveries."[1] It was found that in the instances where credit bidding was present, the value that the estate received was markedly less than the average market price of comparable transactions. Since then, the price of oil has fallen significantly, rebounded slightly and finally started to recover. The purpose of this follow-up article is to see if information on the recent downturn results in different findings.

5 Year Historical Oil and Gas Prices As of Jan 5, 2017



Source: Bloomberg

From January 1, 2014 through December 1, 2016, 114 oil and gas companies sought bankruptcy protection.[2] Of these companies, 23 were publicly listed in the United States at the time of filing. The LoPucki Bankruptcy Research Database ("BRD"), which covers public companies, is useful in analyzing these restructurings. According to the BRD, the restructuring transactions fell into five categories as shown in the following table.

Transaction Type	# of Transactions
Credit bid	4
Sale	4
Debt for equity exchange	12
Quasi-sale	1
Ongoing	2
Total	**23**

There were four transactions that involved credit bidding by secured lenders and one transaction that involved an equity sponsor / senior lender funding a separate company that acquired the bankrupt company's assets in exchange for assuming certain liabilities. The other cases were negotiated asset sales, debt for equity conversions or were ongoing as of January 2017. So it is clear that during the downturn debt for equity exchanges were more popular than sales processes, where the lender was interested in credit bidding – even though both methods often end with the creditors as the new equity owners.

The four cases with credit bidding were evaluated to determine if the prices obtained at auction were comparable to those realized in similar transactions in the same time period. Transactions reported by IHS Herold were used for this analysis. It should be noted that each case is unique and in some cases there are multiple issues that can impact the value obtained.

The following is a brief recap of each of the credit bidding cases.

Quicksilver Resources Inc.

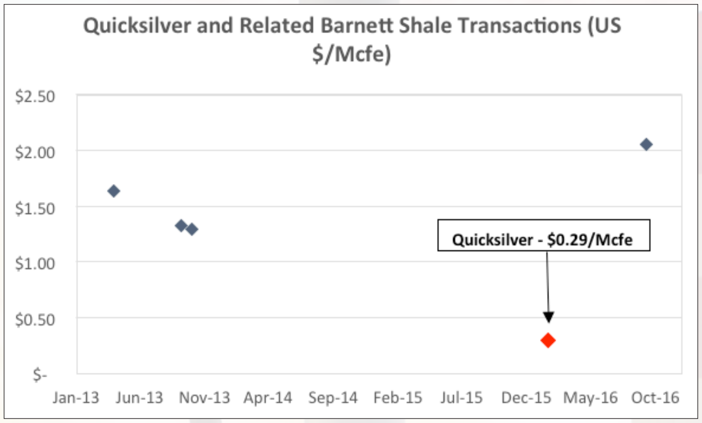
On March 17, 2015, Quicksilver Resources Inc. ("Quicksilver") filed for Chapter 11 Bankruptcy protection in Delaware. Quicksilver's oil and natural gas properties in the United States were principally located in the Barnett

1 http://www.srr.com/article/how-credit-bidding-impacting-oil-and-gas-bankruptcy-recoveries

2 Per the Haynes and Boone LLP Oil Patch Bankruptcy Monitor, updated December 14, 2016.

Shale in north-central Texas and the Delaware Basin in western Texas. Quicksilver's Canadian subsidiaries were not included in the bankruptcy. At December 31, 2014, Quicksilver reported owning approximately 89,000 net acres in the Barnett Shale, with proven reserves of approximately 0.8 trillion cubic feet equivalents (Tcfe). The Delaware Basin properties were largely development stage investments and had few reserves.

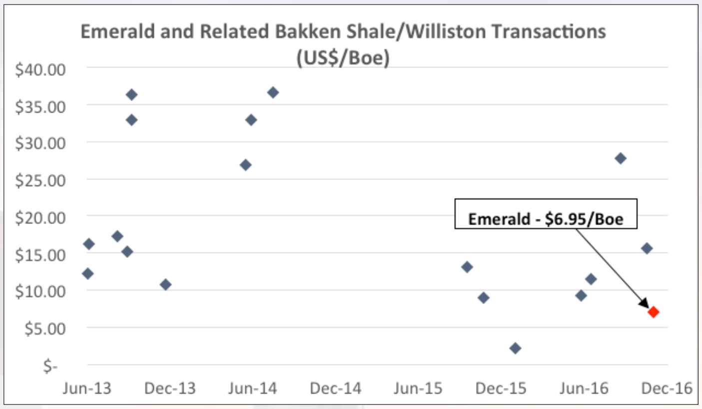
After a months-long marketing process of Quicksilver's assets, an auction was held on January 20 and 21, 2016. Quicksilver declared an all-cash bid in the amount of $245 million from BlueStone Natural Resources II, LLC the highest or otherwise best bid for the oil and gas assets and the successful bid. Quicksilver and BlueStone executed the asset purchase agreement for the sale of the oil and gas assets on January 22, 2016. The implied transaction value was $0.29/million cubic feet equivalents (Mcfe). A lender group was the backup buyer with an offer of $250 million.[3] The lenders' offer was comprised of $93 million in cash and a $157 million credit bid.



Emerald Oil, Inc.

On March 22, 2015, Emerald Oil, Inc. and its affiliates ("Emerald") filed for Chapter 11 Bankruptcy protection in Delaware. The company's assets consisted of approximately 76,000 net acres in the Williston Basin in North Dakota. As of December 31, 2014, the Debtors estimate that their holdings included proved developed oil reserves of approximately 14.0 million barrels of oil (MMBbls) and proved developed natural gas reserves of approximately 11.0 billion cubic feet (bcf), for total reserves of 15.9 million barrels of oil equivalent (MMBoe).

In the months leading up to the Petition Date, the Debtors negotiated with various parties concerning a potential sale of a material portion or substantially all of the Debtors' assets. The Debtors entered into a stalking horse asset purchase agreement with a buyer formed and owned by CL Energy Opportunity Fund, L.P. and SSC Emerald LP. The initial bid was for $73 million, but later increased to $110 million. An auction was scheduled to take place on September 29, 2016. Pre-auction, no party other than the Stalking Horse Bidder and New Emerald Energy, a company formed by a slightly different lender group, submitted a qualified bid. The Stalking Horse Bidder then indicated that it would not participate in the Auction. The Debtors designated New Emerald Energy's $110.5 million bid as the successful bid. New Emerald Energy is jointly owned by Cortland Capital Markets, LLC, CL Energy Opportunity Fund, L.P. and affiliates of Fir Tree Partners. New Emerald Energy's investors were prepetition secured creditors, and credit bid most of the $110 million outstanding on the prepetition secured credit facility and the debtor-in-possession package provided to Emerald. New Emerald Energy's winning offer was comprised of a $94.5 million credit bid, cash in an amount equal to $16 million, and assumption of certain obligations. The Implied Transaction Value per barrel of oil equivalent ($US/Boe) was $6.95/Boe.



RAAM Global Energy Company

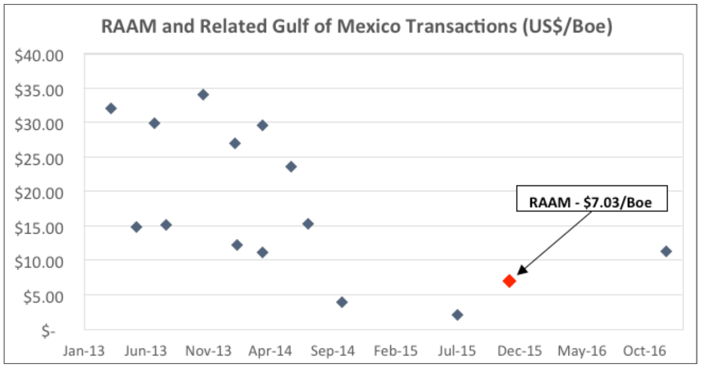
On October 26, 2015, RAAM Global Energy Co. and its affiliates ("RAAM") filed for Chapter 11 Bankruptcy protection in Houston. The company's producing assets were located offshore in the Gulf of Mexico and onshore in Louisiana, Texas, Oklahoma, and California. As of September 30, 2015, the Debtors had estimated total proved oil and natural gas reserves of 8.57 MMBoe. Of the reserves, 47% were in the shallow waters of Louisiana and 53% were onshore.

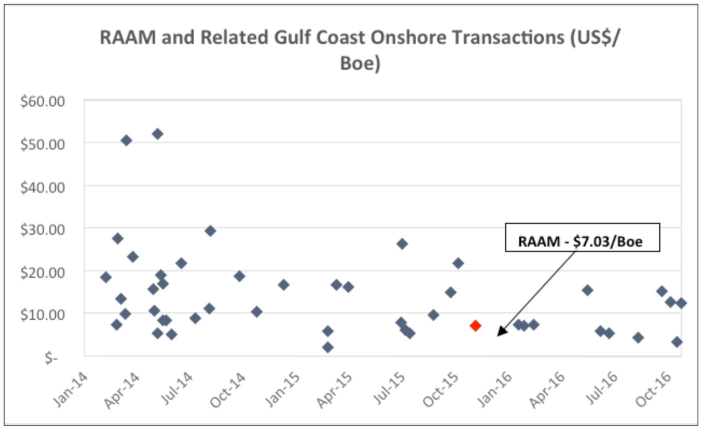
In the months prior to filing for bankruptcy, RAAM sought to restructure its debt by proposing to its noteholders an exchange of notes for a share of $50 million in new notes and 1.17 million shares of RAAM common stock. However, RAAM failed to attain the 99% minimum required by the exchange offer conditions, with only 94.77% of the outstanding noteholders tendering their notes for exchange. In response, the Debtors and their investment bankers undertook a thorough marketing process seeking third party stalking horse bidders. The Debtors were at one point close to finalizing a purchase agreement with a stalking horse bidder for a portion of its assets, but the potential agreement fell through due to changing market conditions. A private equity fund acquired the first lien debt, which was secured by a first lien on substantially all of the Debtors' real and personal property, and entered into a stalking horse agreement with the company. The fund submitted a $58.8 million credit bid, cash in an amount equal to $2.5 million, and assumption of certain obligations. No other buyers participated in the auction. The Implied Transaction Value was $7.15/Boe. The public sale documents do not

3 Amounts given in this article in U.S. Dollars.

Continued from p.7

provide an allocation of the purchase price to the onshore or offshore assets. The following charts assume that the purchase price was split 47%/53% offshore to onshore.



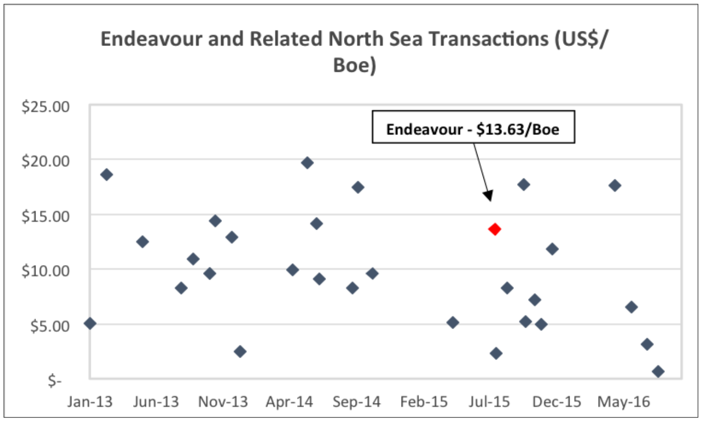


Endeavour International Corp.

Endeavour International Corporation and certain affiliates ("Endeavour") filed for Chapter 11 protection on October 10, 2014. The company held working interests in oil and gas leases in the U.S. and oil and gas licenses in the U.K. Endeavour's U.K. assets comprised approximately 82% of its proven reserves, while its U.S. assets rounded out the remaining 18%. As of December 31, 2014, Endeavour reported total proven reserves of 12.2 MMBoe.

On August 11, 2015, Endeavour sold its U.S. assets in Colorado and the Marcellus and Haynesville basins. Augustus Energy Partners II LLC bought the Colorado assets with a cash offer of $7.85 million. Energy Reserves Group LLC won the auction for the Marcellus and Haynesville shale assets with a cash bid of $1.46 million.

After a contentious process, on August 3, 2015, Endeavour reached an agreement with its unsecured creditors and secured lenders for a $398 million credit bid for equity in the U.K. holding company and an intercompany note from the U.K. entities, as well as a commitment to pay administrative expenses and wind down the U.S. operations. As of December 31, 2014, the U.K. proven and probable (2P) assets totaled 29.2 MMBoe, for an Implied Transaction Value of $13.63/Boe.



Analysis and Comparison

In their 2014 article (see footnote 1), the authors examined six transactions for the effect of credit bidding. Exhibit 1 on page 9, taken from that article, presents a summary of the cases that were studied.

Exhibit 2 contains an analysis of the four recent transactions involving credit bidding discussed above. This analysis reveals that the value realized by the estate in two cases was below market while the other two were consistent with contemporaneous sales. The Quicksilver sale had four comparable sales and realized the lowest transaction price per Mcfe. The Emerald sale had seven comparable transactions during 2015 and 2016 and realized the second lowest transaction price per Mcfe. While the RAAM transaction was more complex to analyze because the debtor did not report an allocation of value to onshore or offshore assets, the 2015 and 2016 onshore and offshore comparable transactions show that the sale price was consistent with the market. The Endeavour International sale of North Sea assets realized a transaction price that was consistent with the market.

Conclusion

This study revealed that compared to findings in the 2014 analysis, in the current wave of oil and gas bankruptcies the time to auction is significantly faster and the number of bidders participating in the auctions is significantly lower.

With the support of this evidence, the authors continue to believe credit bidding can have a negative effect on transaction prices due to other bidders being discouraged from participating when the lender is also a potential buyer. To minimize this, debtors and other interested parties should negotiate terms during the marketing process to ensure that all bidders have a fair opportunity to participate.

Exhibit 1: 2014 Article – Summary of Transactions

Analysis of Certain Aspects of the Sales Process						
Company	Time for Auction Process	Title, Ownership, or Reserve Report Issues	Number of Bidders	Credit Bidding	Sales Price Achieved	Market Comparable Prices
GMX	21 weeks	No material Issues	2	Yes	$1.58 per Mcfe	$2.73 per Mcfe
Delta	20 weeks plus time prior to filing	No material Issues	9	Yes	$0.28 per Mcfe	$2.33 per Mcfe
ATP	16 weeks	No material Issues	5	Yes	$3.60 per Boe	$21.72 per Boe
TXCO	16 weeks	No material Issues	2+	No	$22.79 per Boe	$19.12 per Boe
Edge Petroleum	8 weeks plus time prior to filing	No material Issues	2	No	$2.84 per Mcfe	$1.86 per Mcfe
Transmeridian Exploration	13 weeks	No material Issues	3	Yes	N/A	N/A

Exhibit 2: Recent Cases – Summary of Transactions

Analysis of Certain Aspects of the Sales Process						
Company	Time for Auction Process	Title, Ownership, or Reserve Report Issues	Number of Bidders	Credit Bidding	Sales Price Achieved	Market Comparable Prices
Quicksilver Resources Inc.	15 weeks	No material Issues	2	Yes (Back up Bidder)	$0.29 per Mcfe	$1.58 per Mcfe
Emerald Oil, Inc.	4 weeks plus time prior to filing	No material Issues	2	Yes	$6.95 per Boe	$19.18 per Boe
RAAM Global Energy Company	5 weeks plus time prior to filing	No material Issues	1	Yes	$7.15 per Boe	$18.85 per Boe (offshore) $14.28 per Boe (onshore)
Endeavour International Corporation	11 weeks	No material Issues	1	Yes	$13.63 per Boe	$9.76 per Boe

ABOUT THE AUTHORS

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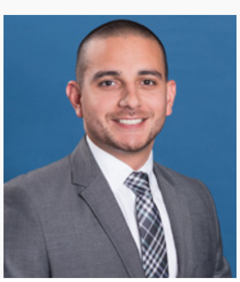

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Decline in Oil: A Contagion Through Latin America's Related Sectors

MICHAEL FEDER, BRAD HUNTER, CIRA,
GABE KOCH, CIRA, AND MARK BARNETT
AlixPartners, LLP

The fallout from the dramatic collapse in oil prices during the past two years continues to spread (see Exhibit 1), and Latin America's beleaguered oil and gas industry is bearing the brunt. The economies of Brazil, Mexico, Colombia, and Venezuela—each a significant oil & gas producer—all have taken hits. But it's not just a potential recession or the effects on the region's GDP that are causing concern.

Based on a recent AlixPartners Latin America team review of the financial performances of approximately 500 publicly traded Latin American businesses during the past five years, other sectors such as materials and industrials have been negatively affected as well. And when the decline in Chinese imports is also considered, the risks become acute.

These businesses may now have to accept that prices are likely to stay low—or even fall further—and thus adapt their business plans accordingly. They may have to cut costs, reorganize, and refocus on their core businesses. And in the face of falling valuations, they should consider foreign investment through mergers and acquisitions to fund a return to health.

Contagion Through Countries

The crash in oil prices affected Latin America's players in varying but equally damaging ways.

In Brazil, the crash pointed out improprieties at national oil company Petrobras[1] and, in an economy fueled by commodities, helped plunge the nation into a deep recession. GDP shrank 3.8% in 2015; a further decline of 3.3% is estimated during 2016 and a meager growth rate of 0.2% is forecasted in 2017.[2,3]

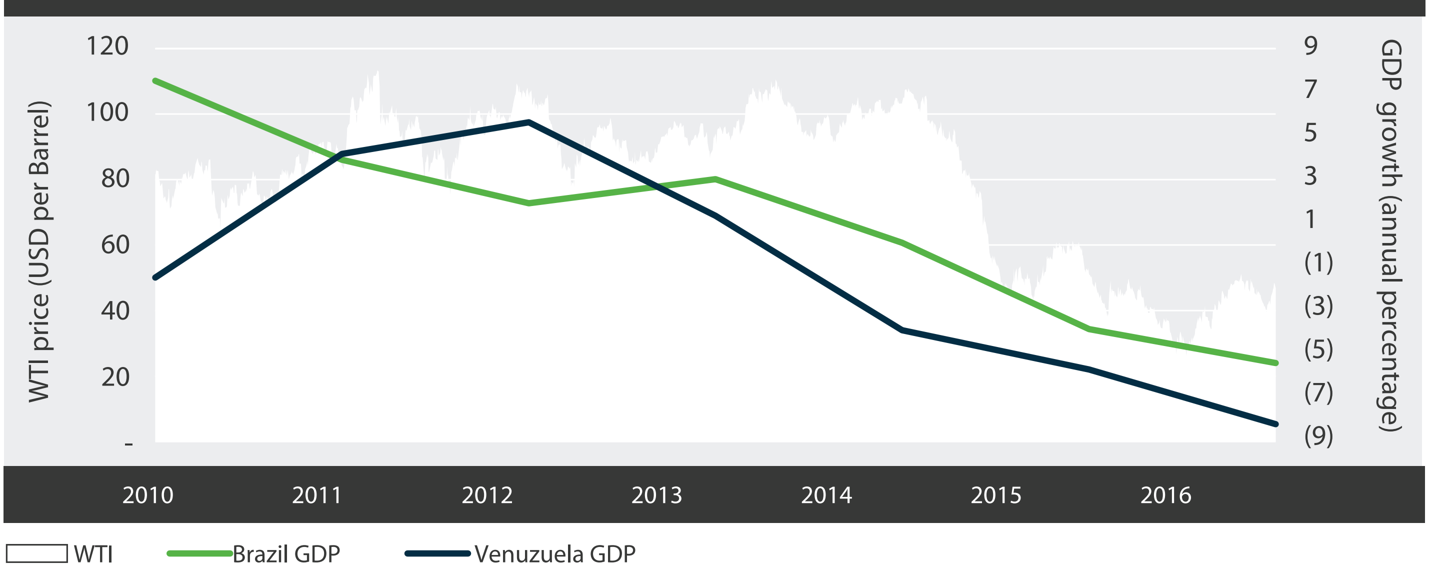
In Venezuela, where oil export has been the major driver of economic growth, the collapse in pricing combined with challenging government policies and corruption served to spark a severe depression.

The China Factor

Latin American trade with China increased significantly from 2000, multiplying 22-fold by 2013.[4] In the final year of the commodities boom, exports to China grew to US$112 billion.[5] By 2015, China had become the largest trading partner of Brazil, Chile, and Peru and is second only to the United States overall.[6] Unfortunately, economic

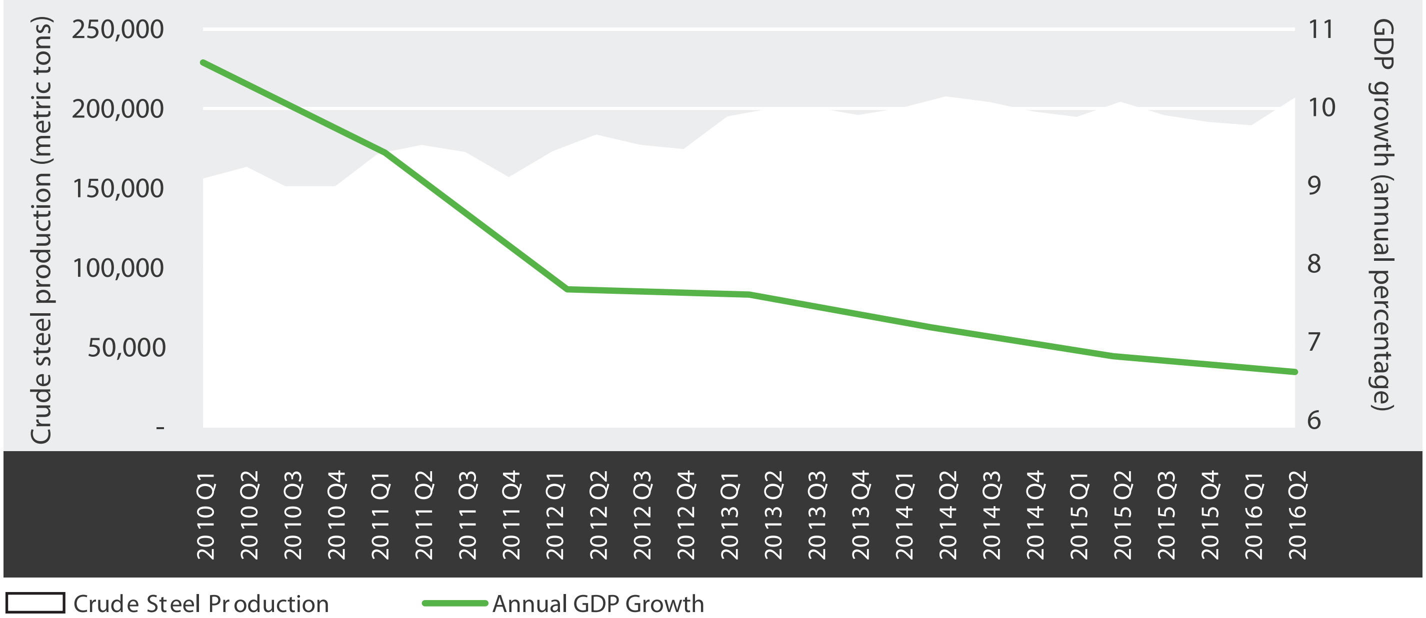
1 David Segal, "Petrobras Oil Scandal Leaves Brazilians Lamenting a Lost Dream," New York Times, August 7, 2015. Accessed September 20, 2016, http://www.nytimes.com/2015/08/09/business/international/effects-of-petrobras-scandal-leave-brazilians-lamenting-a-lost-dream.html?_r=0
2 http://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG?locations=BR and https://www.imf.org/external/pubs/ft/weo/2016/update/02/
3 https://www.imf.org/external/pubs/ft/weo/2017/update/01/pdf/0117.pdf
4 http://www.oecd.org/economy/press-release-latam-econ-outlook-2016.htm
5 https://www.bu.edu/pardeeschool/files/2015/02/Economic-Bulletin-2015.pdf
6 http://www.oecd.org/economy/press-release-latam-econ-outlook-2016.htm

EXHIBIT 1: WEST TEXAS INTERMEDIATE (WTI) PRICE VERSUS GDP GROWTH



Source: Worldbank, World Steel Assocation

EXHIBIT 2: CHINESE STEEL PRODUCTION VERSUS GDP GROWTH



Source: Worldbank, World Steel Assocation

growth in China has slowed significantly, further depressing the economies of its significant trading partners in Latin America as described below.

Not only has economic growth weakened in the past five years in China, but also China's steel production—an industry that has expanded in the past 20 years to become the world's largest—is showing signs of contraction (*see* Exhibit 2). In 2015, China produced approximately 24 million fewer tons of steel than it did in 2014, marking both a 3.1% dip and the first annual decline in nearly two decades.[7] Although China experienced a production record at the end of the second quarter of 2016, a further 3% contraction is anticipated during the rest of the year, bringing continued concerns to Latin American markets.[8] This outlook may reflect new norms based on the National Bureau of Statistics of China's lowering of its 2016 growth target to 6.5-7.0% and reducing the five-year growth rate to 6.5%.[9] For Latin American economies, the slowdown in China has meant that China imports from the region fell more than 17% from July 2014 to July 2016,[10] thereby contributing significantly to the economic malaise in the region.

Contagion Through Sectors

Furthermore, the downturn appears to be spreading at an alarming rate through connected industries in the energy and utilities sector. The Altman Z-scores of 500 Latin American companies show a dramatic drop in the sector to less than half since 2011.

As the energy and utilities industry fell down the distress curve, it took with it other sectors that rely on heavy capital investment and high commodity demand—namely, industrials and materials.

The Latin American materials sector appears to be heavily dependent on demand from foreign nations and is often largely tied to economic growth around the world—in particular, in China. Further, it is estimated that 70% of Latin America's exports to China are raw materials—a telling sign of the significant decline in that industry (*see* Exhibit 3)[11] Given such reliance, as investment began to slow and as China's economic expansion began to lose steam, the materials sector started demonstrating signs of depressed

EXHIBIT 3: LATAM TOP FIVE EXPORTS TO CHINA 2009 – 2013

Export	Percentage of total exports
Iron ore and concentrates	20%
Soybeans and other oilseeds	18%
Copper	14%
Copper ores, concentrates	10%
Crude petroleum	9%
Total of top five	71%

Source: China-Latin America Economic Bulletin 2015 Edition

7 Nicholas Walters and Soo Jung Kim, "World Crude Steel Output Decreases by –2.8% in 2015," World Steel Association, January 25, 2016. Accessed September 20, 2016, https://www.worldsteel.org/media-centre/press-releases/2016/--World-crude-steel-output-decreases-by--2.8-- in-2015.html

8 "China's Old Economy Springs June Surprise with Steel Record," Bloomberg.com, July 14, 2016. http://www.bloomberg.com/news/ articles/2016-07-15/china-s-giant-steel-industry-just-notched-up-record-daily-output

9 Mark Magnier, "China Begins to Tackle Its 'Zombie' Factory Problem," Wall Street Journal, March 3, 2016. Accessed September 20, 2016, http:// www.wsj.com/articles/china-readies-plan-to-confront-its-zombie-problem-1457024868

10 http://www.tradingeconomics.com/china/imports-from-latin-america

11 http://www.coha.org/china-and-latin-america-what-you-need-to-know/

Continued from p.11

EXHIBIT 4: ALTMAN Z-SCORE

Industry	2011	2012	2013	2014	2015	2016
Energy and utilities	2.56	2.50	1.56	1.55	1.04	1.06
Industrials	2.46	2.42	2.29	2.31	1.97	1.82
Materials	4.68	3.31	2.75	2.44	2.15	2.06

Source: Capital IQ, AlixPartners analysis

growth. In a coupling of weak foreign demand with local economic challenges caused in part by the crash in oil, materials companies in the AlixPartners research group[12] reported an average annual revenue decline of 6%.

In the past five years, the industrials market has gone from being a medium-healthy industry with an average Altman Z-score of 2.46 in 2011 to a reported score of 1.82 in 2016 (*see* Exhibit 4). In addition, revenues in the industrial companies reviewed decreased on average by 15.8% in Argentina, Brazil, Chile, Colombia, Mexico, and Peru. Of particular note, the annual revenues of surveyed industrial companies in Brazil decreased most severely during that time, with a 23.9% downturn.[13]

At first, all of that may seem surprising given that oil rents are only 2.2% of Brazil's GDP.[14] But the explanation for the larger impact in Brazil can be found by understanding how lower oil prices have served to exacerbate other key issues the broader economy faces. Those issues include declining demand for commodities from China, which is Brazil's largest trading partner and which receives nearly one-fifth of all exports (*see* Exhibit 5); the so-called Lavo Jato (Car Wash) bribery scandal; and junk bond ratings from credit agencies, which were caused in part by extravagant levels of government pension spending. All of those elements have forced companies to often review their capital-spending plans.

In contrast to Brazil, Mexico actually saw a slight increase of 3.6% growth in industrial revenues from 2011 to 2016, based on AlixPartners research group data. Although Mexico has heavy dependency on oil, it also has the advantage of industrial construction and manufacturing production along the U.S. border—for example, in maquiladoras—which has enabled Mexico's industrials sector to remain relatively healthy while Brazil, Argentina, and the other Mercosur countries have struggled. Put another way, Mexico's proximity to the fundamentally improving U.S. economy and fewer trade blocks have helped diversify the Mexican economy enough for the volatile commodities trade to have exerted less impact. However, these advantages may be inhibited by the recent political outcome in the United States presidential election.

So, What Can Companies Do?

As the market returns to a steady-state economy, albeit at weaker levels, there appears to be a settling in of lower commodity prices. This means the outlook for energy and utilities and for industrials and materials, as a whole, remains poor. To return to health, companies in those sectors must consider the following actions.

Accept a new normal. Companies whose strategies have been based on the belief that a rising-price environment is just around the corner are finding out that the economy can be wrong longer than companies can be right. Business plans should be built on lower revenues as the base case rather than on the expectation—or hope—of a ramp-up in pricing.

12 S&P Capital IQ data set containing about 500 public Latin American companies. Data ranges from 2011 to 2016.

13 Based on combined revenue of the industrial companies sampled from Brazil.

14 http://data.worldbank.org/indicator/NY.GDP.PETR.RT.ZS

EXHIBIT 5: MARKET SHARE OF LATAM EXPORTS TO THE WORLD AND CHINA, 2009-2013

	Iron (ores, concentrates)		Soybeans and other oilseeds		Copper (refined)		Copper (ores, concentrates)	
	World market	China	World market	China	World market	China	World market	China
Argentina	-	-	7%	10%	-	-	3%	-
Brazil	26%	16%	25%	34%	1%	1%	3%	1%
Chile	1%	1%	-	-	21%	27%	32%	28%
Mexico	-	-	-	-	1%	1%	2%	6%
Peru	1%	1%	-	-	2%	2%	15%	17%
LatAm total	28%	18%	32%	44%	25%	31%	55%	52%

Source: China-Latin America Economic Bulletin 2015 Edition

Act on the new normal. Based on a resetting of revenue expectations for the next three years, companies should look at all elements of their cost structures and determine which costs are critical to operations and which costs exist as holdovers from the price boom. When possible, selective use of local restructuring laws may enable companies to shed unnecessary commitments. Companies should also consider reorganization and a streamlining of the organization to identify unnecessary costs, though the potential benefits of doing that must be compared with the cash outlays involved—especially in countries with very specific severance policies.

Look for new money. The often heavy debt loads that companies took on so they could take advantage of boom periods put some companies in precarious positions by being forced to conserve cash and being challenged to fund necessary changes. However, as company valuations have gone down, companies' attractiveness to foreign investment has increased. And mergers-and-acquisitions activity can help companies refocus on their core businesses and thereby restore profitability.

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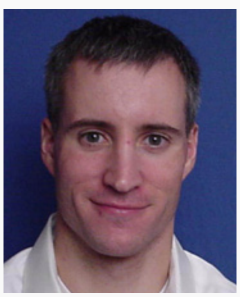

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Till Realized: Calculating Objective Chapter 11 Cramdown Rates without Expert Testimony

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The landmark 2004 U.S. Supreme Court case of *Till v. SCS Credit Corp.*[1] has been a boon for many restructuring practices across the country. In *Till*, the Court addressed how bankruptcy courts should determine "cramdown" interest rates in bankruptcy cases. Even in relatively smaller Chapter 11 cases to which *Till* is routinely extended, with claims of "merely" $20 million, it is not unusual for dueling *Till* experts to bill hundreds of thousands of dollars for disputes about methodologies, expertise, and assumptions. For the cynical among us, the work product is often less than objective or, worse, not helpful to the court. To be sure, much has been written about these *Till* expert contests. However, little, if anything, has been written about those parties—especially debtors—who cannot afford to engage a *Till* expert. What then? In this article, the authors explain why a debtor may, if case economics do not justify otherwise, establish a *Till*-compliant cramdown interest rate objectively and economically, all without the necessity of engaging an expert witness.

Overview of *Till v. SCS Credit Corp.*

In dozens of decisions and hundreds of articles, judges, attorneys, academics, financial experts, and other restructuring professionals have spent almost thirteen years analyzing every word and diagramming every sentence in *Till*. Thus, readers are likely somewhat familiar with the decision. As a refresher, though, the Supreme Court determined in *Till* that courts should employ the "formula approach" to calculate the appropriate "cramdown" rate of interest in a Chapter 13 case.[2] That is, courts should determine the interest rate by starting with the national prime rate and then increasing that rate by an amount sufficient to account for debtor-specific risks of nonpayment, including the "circumstances of the estate, the nature of the security, and the duration and feasibility of the reorganization plan."[3]

In deciding so, the Court reviewed four competing approaches: (1) the Formula Approach, (2) the Coerced Loan Approach, (3) the Presumptive Contract Rate, and (4) the Cost of Funds Approach.[4] A plurality of four Justices led by Justice Stephens chose the Formula Approach; four Justices led by Justice Scalia pushed for the Presumptive Contract Rate; and a concurring Justice Thomas opted for the Formula Approach, but with the caveat that a risk-free rate should suffice without the need for debtor-specific risk adjustments.[5] Importantly, all of the Justices except Justice

1 541 U.S. 465 (2004).
2 *Till*, 541 U.S. at 474.
3 *Id.* at 479.
4 *Id.* at 477-78.
5 *Id.* at 479 (plurality opinion); 491 (dissent); 487 (concurrence).

Thomas agreed that the cramdown rate should compensate creditors for the risk of plan default.[6] However, those eight Justices disagreed about which approach most appropriately compensates creditors for that risk.

More importantly for this article, all nine Justices agreed that, regardless of which approach a court employs, the approach should be objective to ensure consistent treatment of similarly-situated creditors and minimize the need for costly and time-consuming evidentiary hearings.[7] First, the Court pointed out that because so many Bankruptcy Code provisions involve discounting payment streams to present value, it is important that judges "follow essentially the same approach when choosing an appropriate interest rate."[8] Second, the Court concluded that "Congress would favor an approach that is familiar in the financial community and that minimizes the need for expensive evidentiary proceedings."[9] Third, the Court held that the "cramdown provision mandates an objective rather than a subjective inquiry."[10] Finally, the Court held that the approach "should aim to treat similarly situated creditors similarly" and "ensure that an objective economic analysis would suggest the debtor's interest payments will adequately compensate all such creditors for the time value of their money and the risk of default."[11]

With those considerations in mind, the Court rejected the Coerced Loan, Presumptive Contract Rate, and Cost of Funds approaches because, in pertinent part, they are "complicated" and impose "significant evidentiary costs."[12] However, in the Court's view, the Formula Approach "has none of [those] defects."[13] On the one hand, a court must "hold a hearing at which the debtor and any creditors may present evidence about the appropriate risk adjustment."[14] On the other hand, much of that evidence should already be in the debtor's bankruptcy filings or in the hands of the creditors who "are likely to have readier access to any information absent from the debtor's filing . . ."[15] Indeed, the requirement of upward adjustments, if any, "places the evidentiary burden squarely on the creditors."[16] Thus, the Court concludes that the Formula Approach "entails a straightforward, familiar, and objective inquiry, and minimizes the need for potentially costly additional evidentiary proceedings."[17]

Notably, there is no explicit requirement that *Till* should apply to Chapter 11 cases. After all, the *Till* decision involved a $4,895 truck loan in a Chapter 13 case. Further, *Till*'s infamous footnote 14 (dealing with the issue of whether there is an "efficient market" for proposed plan terms),[18] Justice Scalia's contention that the Presumptive Contract Rate Approach is superior to the Formula Approach,[19] and even the dispute about whether the prime rate is an appropriate presumptive starting rate[20] have "cracked the door" just wide enough to permit objecting parties to argue that *Till* should have no application in Chapter 11. Nevertheless, most courts that have addressed the issue have extended *Till* to Chapter 11 cases as persuasive, if not binding authority, for determining cramdown interest rates.[21] The present value discounting embedded in § 1129(b)(2)(B)(i)'s "fair and equitable" requirement is simply too similar to the discounting contemplated in § 1325(a)(5)(B) for courts to ignore *Till* in Chapter 11.

In any event, let us bypass those disputes, assume for this article that *Till*'s Formula Approach applies in Chapter 11 cases of all shapes and sizes, and focus on two questions. First, have Chapter 11 practitioners applied *Till* as objectively, consistently, and economically as possible? The answer is "No." Second, is it even possible to apply *Till* in an objective, consistent, and economical fashion? Even more specifically for this article, is it possible to apply *Till* objectively, consistently, and economically without the use of an expert witness? With some fundamental limitations, the authors submit that the answer is "Yes." That is, it is possible to determine a *Till* rate under the Formula Approach without expert testimony that sufficiently compensates a creditor for the risk that a debtor may default.

Tills' Subjective and Expensive Track Record in Chapter 11

Despite the Supreme Court's clear guidance directing an objective, consistent, and economical application of the Formula Approach, disputes over the appropriate cramdown discount rate have become a cottage industry in Chapter 11 cases, resulting in what some observe as a waste of time, resources, and money. Additionally, many of these disputes appear to be motivated not by a desire to ensure appropriate risk compensation, but by a strategy to block plan confirmation by demanding "eye-popping" interest rates that will render a plan infeasible.[22]

In fact, in most small cases where the secured claim is under $2 million, a 1% difference in interest rate changes the lender's compensation by less than $20,000 a year, begging the question of why a lender would spend multiples of that

6 *Id*. at 485-86.
7 *Id*. at 474-75.
8 *Id*. at 474.
9 *Id*. at 474-75.
10 *Id*. at 476.
11 *Id*. at 477.
12 *Id*.
13 *Id*. at 478.
14 *Id*. at 479.
15 *Id*.
16 *Id*.
17 *Id*.

18 *Id.* at 476, n.14. *See also* Bruce A. Markell, *Fair Equivalents and Market Prices: Bankruptcy Cramdown Interest Rates*, 33 Emory Bankr. Dev. J. 91 (2016) (exploring whether an efficient cramdown market exists).
19 *Id.* at 498.
20 Some suggest that, despite *Till*'s reference to the prime rate, other rates, like the U.S. Treasury rate or LIBOR rate, are more appropriate risk-free starting points in Chapter 11; we shall save our disagreement for another day.
21 *See*, *e.g.*, *In re Texas Grand Prairie Hotel Realty, L.L.C.*, 710 F.3d 324, 333 (5th Cir. 2013). *See generally*, *In re MPM Silicones, LLC*, No. 14-22503-RDD, 2014 WL 4436335 (Bankr. S.D.N.Y. Sept. 9, 2014), *aff'd*, 531 B.R.321 (S.D.N.Y. 2015).
22 The Supreme Court instructed that if a court "determines that the likelihood of default is so high as to necessitate an 'eye-popping' interest rate . . . the plan probably should not be confirmed." *Till*, 541 U.S. at 480-81 (internal citation omitted).

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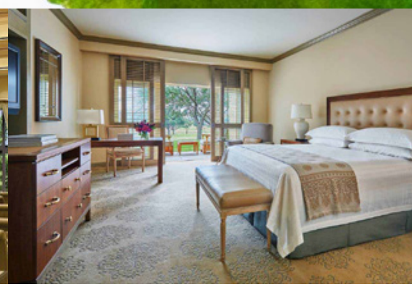

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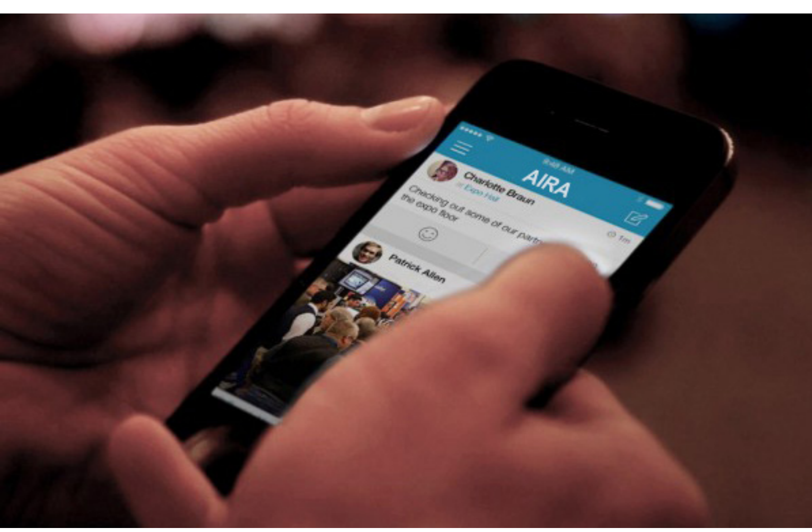

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amount in litigation costs to argue for the increase.[23] In many of those cases, the underlying motivation is not so much risk compensation as it is gamesmanship to extract additional concessions from a debtor who wishes to avoid the cost, risk, and delays of contested confirmation. In cases in which a contested rate is adjudicated by the court, in all but the most complex and largest matters, this exercise will result in a Pyrrhic victory for the prevailing party, as the burden and cost of litigation will outweigh any economic benefit of achieving the appropriate risk-adjusted rate.[24]

Ultimately, and typically at the expense of debtors and, by extension, unsecured creditors, the negotiation of cramdown interest rates can result in an interest rate that overcompensates the secured lender for the plan's risk of default. This anomaly weighs in favor of the lenders who typically have greater resources and can make credible threats to fight and delay plan confirmation.

The Expected Loss Formula as an Objective, Evidentiary Solution

Under *Till*'s Formula Approach, an interest rate is calculated to compensate a creditor for the time value of money and the risk of plan default.[25] It starts with a presumptive "national prime rate" and then calls for rate adjustments to compensate for debtor-specific risks.[26] The national prime rate is the published rate that a "commercial bank should charge a creditworthy commercial borrower to compensate for the opportunity costs of the loan, the risk of inflation, and the relatively slight risk of default."[27] The debtor-specific risks (the *Till* Factors) include, but are not limited to, the "circumstances of the estate, the nature of the security, and the duration and feasibility of the reorganization plan."[28]

To more clearly understand how *Till*'s Formula Approach might be applied objectively, consistently, and economically, all without the *necessity* for expert testimony, it is useful to start with the concept of risk, to translate that concept into well-understood "ordinary lending practices,"[29] and then to view *Till* in light of those practices. Following that path is consistent with *Till* because, again, the Court emphasized that "Congress would favor an approach that is familiar in the financial community and that minimizes the need for expensive evidentiary proceedings."[30] Therefore, let us start with the fundamentals. Specifically, the International Organization for Standardization (ISO)[31] defines "risk" as the "effect of uncertainty on objectives" and "level of risk" as the "magnitude of a risk" or "combination of risks, expressed in terms of the combination of consequences" and "their likelihood."[32]

Standard lending rates, such as the national prime rate, compensate a lender for both the cost of money and the risk of lending. Specifically, a commercial lending interest rate is comprised of seven parts: Real Risk-Free Rate (base, risk-free "cost of money"), Expected Inflation Rate (expected near-term or current inflation rate), Term Premium (premium demanded for unexpected inflation over the term), Liquidity Risk Premium (premium demanded for less liquid investments), Market Risk Premium (premium demanded for economic risk of decline in the overall market), Operational Risk Premium (premium demanded for the business of lending), and Credit Risk Premium (premium demanded for debtor-specific risks). The Real Risk-Free Rate and the Expected Inflation Rate reflect the time value of money and make up the "Nominal Rate."[33] The Term, Liquidity, Market, Operational and Credit Risk parts relate to "risk" and make up the risk premiums, if any, for a given discount rate.

Under *Till*, the national prime rate accounts for all of those interest rate components except for that portion of the Credit Risk that is in excess of the Credit Risk presented by a prime quality borrower. Specifically, the national prime rate includes (i) the time value of money interest components in the Nominal Rate (*i.e.*, Real Risk-Free Rate and Expected Inflation Rate) and (ii) four of the five risk premiums (the Liquidity, Market, Operational and Credit Risk Premiums). Because the national prime rate only includes a Credit Risk Premium commensurate with a prime quality borrower, *Till* requires compensation for *debtor-specific* risks and a Term Premium adjustment, as necessary.[34]

In turn, the so-called "Expected Loss Formula" provides a reliable tool for quantifying and categorizing those remaining debtor-specific plan risks under *Till*.[35] Under the Expected Loss Formula, Expected Loss (EL) equals Probability of Default (PD) x Loss Given Default (LGD) x

23 From a debtor's perspective, even minor increases in the interest rate can undermine plan feasibility, result in higher balloon payments at plan maturity, and jeopardize the viability of plan exit financing.

24 To demonstrate, a 0.50% percent increase in the interest rate on a $1,000,000 claim will increase total risk compensation by only $25,000 over the life of a plan proposing a five year payout.

25 *Id*. at 474.

26 *Id*. at 479.

27 *Id*.

28 *Id*.

29 *Id*. at 478.

30 *Id*. at 474-75.

31 ISO is an independent, non-governmental international organization with a membership of 162 national standards bodies. It brings together experts to share knowledge and develop voluntary, consensus-based, and market-relevant International Standards.

32 ISO 31000:2009 (Risk Management – Principles and guidelines) at §§ 2.1, 2.23 (an ISO specification to standardize risk management for all types of organizations).

33 From the "Fisher Equation" (Real Interest Rate ≈ Nominal Interest Rate – Inflation Rate).

34 The Term Premium adjustment becomes necessary in cases in which a plan of reorganization contemplates a fixed rate of interest. Because the national prime rate is a variable interest rate, a Term Premium adjustment would be required to account for long-term inflation expectations above or below the current inflation rate embodied in the national prime rate. The amount of the Term Premium adjustment is equal to the "Breakeven Inflation Rate" minus the then current inflation rate. While beyond the scope of this article, this adjustment is easily and objectively calculable from publicly-available information.

35 The Expected Loss Formula is an internationally-accepted risk management tool adopted in ISO 31000. International banking regulators also adopted it under the Basel Accords issued by the Basel Committee on Banking Supervision. Although the use of the formula in modern risk management originated with Bankers Trust in the early 1970s, the concept dates back to the ancient Phoenicians. They measured frequency and severity of illnesses among rural farmers to estimate expected productivity losses.

Exposure at Default (EAD).[36] The "Probability of Default" is the likelihood that a plan default will occur. The "Loss Given Default" is the amount of loss that occurs as a result of a default. "Exposure at Default" is usually the outstanding debt balance at the anticipated default date. For Chapter 11 plans proposing a relatively long amortization period, it is usually safest to set EAD at the original claim balance because plan defaults, if they occur, usually occur during the early stages of repayment rather than late in repayment.

With that, the *Till* factors line up nicely with the Expected Loss Formula, such that proposed risk-based compensation under a plan will satisfy *Till* if such compensation is greater than or equal to a creditor's Expected Loss (EL) under a given plan. Loss Given Default covers *Till*'s "nature of the security" factor. Probability of Default covers the remaining debtor-specific risks under *Till* (*i.e.*, the "circumstances of the estate" and "duration and feasibility of the reorganization plan" factors).

Arguably then, satisfying *Till*'s requirement that the rate determination be objective, consistent, and economical largely depends on the Probability of Default calculation. This is due to the fact that the Probability of Default is the part of the calculation that is most vulnerable to subjectivity and, without limiting assumptions, requires the assistance of an expert. Put another way, except for the Probability of Default component, each of the components of the Expected Loss Formula is entirely objective, easily calculated using basic math, and based on readily-available industry underwriting criteria (*e.g.*, published starting rate, Loan to Value Ratio, Debt Service Coverage Ratio, Debt Yield Ratio, etc.).

Therefore, the Probability of Default calculation is at the heart of *Till*. In its most subjective form, that calculation commonly plays out in Chapter 11 cases in three steps. First, competing experts will wax eloquent about loan underwriting and risk management concepts, generally, to establish their expert qualifications. Second, those experts will then describe to the court the extent to which the debtor and its plan depart from the typical underwriting criteria for a prime quality borrower (i.e., from the *Till* factors). Third, they will declare, often with little support, the rate increase that is appropriate for each variance. The authors submit that an expert can minimize, but not eliminate, the subjectivity in the third step by not only identifying those variances, but also calculating the probability that each variance will cause a plan default. Indeed, the sum of those probabilities is the Probability of Default for that debtor.

Unfortunately, many debtors, particularly those with liabilities totaling less than $2 million, simply cannot justify hiring or even afford to hire an expert to perform any variety of the Probability of Default calculation, subjective or objective. Thus, the dilemma: If a debtor cannot afford to pay an expert to determine each of the *Till* rate adjustments, then is it even possible for a debtor to establish, with evidentiary sufficiency, a *Till*-compliant cramdown rate? The authors submit that, in a pinch, § 1129(a)(11) of the Bankruptcy Code resolves that evidentiary dilemma for debtors who can live without the bespoke and, often, but not always, more favorable interest rate determination of an expert.

Specifically, § 1129(a)(11) requires, as a condition for plan confirmation, that confirmation of a plan is "not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor to the debtor under the plan, unless such liquidation or reorganization is proposed in the plan."[37] Stated differently, a feasible and, thus, confirmable plan has, by definition, a Probability of Default of 50% or less. Logically, then, a plan cannot be confirmed if the Probability of Default is greater than 50%. If an expert establishes that the Probability of Default is greater than 50%, that conclusion simply suggests that the plan is not feasible and, thus, not confirmable, period.[38] Therefore, setting the Probability of Default at 50% (the maximum Probability of Default that the Bankruptcy Code will permit before feasibility fails) would enable a debtor to establish a *Till*-compliant cramdown rate without an expert. Because that maximum rate reflects the highest confirmable risk-adjusted discount rate that can be assessed under a feasible plan,[39] it must satisfy *Till*, by definition.

Maximizing the Probability of Default at 50% takes the expert out of the process altogether because it maximizes the debtor-specific risks that an expert would be asked to calculate—expert testimony could only *lower* the debtor-specific adjustments. Thus, a debtor without means can still satisfy the *Till* requirements that the Supreme Court read in the Code's "fair and equitable" requirement under § 1129(b)(2)(B)(i). By taking the expert out of the process and adopting the Expected Loss Formula with a locked-down and capped 50% Probability of Default, the debtor can propose an entirely objective discount rate and even avoid a costly *Till* contest. Although this approach still leaves the debtor with the burden to prove feasibility, it is an unavoidable burden that all debtors already share.

That is not to say that capping the Probability of Default at 50% would give the debtor a free ride at the expense of creditors. To the contrary, a rate calculated with the assumption of the highest feasible Probability of Default will *overcompensate* secured lenders in all but the most marginal of confirmable Chapter 11 plans. Further, such excessive compensation will, in all but the largest cases, be less than the cost and risk associated with litigating a contested rate. Therefore, there will be cases that justify obtaining a precise calculation of Probability of Default and, thus, that require expert testimony (*e.g.*, (relatively larger cases and cases having characteristics which create an indisputably low risk of default). But, even in those cases, the scope of expert testimony should be limited to

36 For example, if a loan has a balance of $75 (EAD), a projected 20% loss on default (LGD), and a 50% probability of default (PD), then Expected Loss (EL) = 50% (PD) x 20% (LGD) x $75 (EAD), or $7.50.

37 11 U.S.C. § 1129(a)(11).

38 *See Till*, 541 U.S. at 480 (suggesting that rate adjustments outside of the common 1-3% range beg the question of feasibility). *See also* Rafael I. Pardo, *Reconceptualizing Present-Value Analysis in Consumer Bankruptcy*, 68 Wash. & Lee L. Rev. 113, 147-50 (2011) (while emphasizing the difference between plan feasibility in Chapter 11 and 13 cases, Professor Pardo discusses the connection between *Till*, probability of default, and § 1129(a)(11)).

39 Mathematically, a higher rate implies a Probability of Default that exceeds 50% and, thus, an infeasible plan.

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determining the Probability of Default—testimony which, in large part, is already necessary under § 1129(a)(11).

To demonstrate, consider a $1 million secured claim having real estate collateral valued at $1 million. In the current lending market, a prime quality commercial borrower would only be able to borrow up to 80% of the collateral value or $800,000. It follows that, in the event of default, the creditor under the Chapter 11 plan would incur a $200,000 (20%) greater loss than it would have incurred under a default on a properly-margined loan to a prime quality borrower. Thus, the Loss Given Default is equal to 20% and reflects the incremental risk of the plan relative to a prime quality borrower assuming certainty of default. However, because default is not a certainty and, in fact, not even likely assuming compliance with § 1129(a)(11), the determination of risk must consider the Probability of Default. Using 50% as the maximum confirmable Probability of Default results in an Expected Loss of $100,000.[40] Thus, the creditor is entitled to a maximum of $100,000 in risk-based compensation over and above the national prime rate. Assuming a 5 year plan and a 20 year amortization, the national prime rate would have to be increased by 2.09%[41] to provide this additional compensation.[42]

This example demonstrates an entirely objective calculation of the risk-based compensation that can be completed with nothing more than a basic knowledge of current lending guidelines and rudimentary mathematics. Assuming that the debtor can demonstrate plan feasibility in this example, there is no valid argument supporting risk-based compensation in excess of $100,000.

Conclusion

Large, multi-billion dollar Chapter 11 cases (and the professionals engaged in those cases) will continue to drive the evolving judicial interpretations of *Till*. When the dust settles, debates about *Till*'s applicability in Chapter 11 – as well as debates about methodologies, presumptive rates and efficient lending markets – will eventually subside. That evolution might very well narrow the scope, cost, and subjectivity of expert testimony about *Till* rates in the manner that the Supreme Court intended. However, and particularly in the meantime, the vast majority of Chapter 11 debtors will continue to struggle to justify or afford a *Till* rate expert. Appealing to well-settled principles of risk management and loan underwriting, the authors humbly submit that, if a debtor is willing to accept the most pessimistic view of feasibility that Chapter 11 permits and can establish such feasibility, then a debtor can, without the necessity of an expert witness, establish an objective, *Till*-compliant cramdown rate.[43]

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40 50% (PD) X 20% (LGD) X $1,000,000 (EAD) = $100,000 (EL).

41 Utilizing an amortization schedule commonly available as an Excel template, it can be determined how much the rate would need to increase to produce an additional $100,000 in interest charges over the life of the plan.

42 Not coincidentally, this scenario falls within the 1% to 3% "rule of thumb" that many read into *Till* as a reasonable range of adjustment. *See, e.g., Standing Order Designating Presumptive 11 U.S.C. § 1325(a)(5)(B) Interest Rate* (Bankr. N.D. Miss. Jul. 22, 2014) (following its Southern District counterpart, the court set the *Till* rate in Chapter 13 cases filed after August 1, 2014 at 5.00%). In fact, in most common scenarios, the resulting risk adjustment falls within the 1% to 3% range with fluctuations based on market and claim "loan to values" and plan duration. However, if a debtor can demonstrate significantly lower Probability of Default, then the adjustment will frequently fall below the 1% range, with adjustments exceeding 3% in scenarios having collateral with traditionally low collateral advance rates or rapid collateral depreciation.

43 The views expressed in this article do not necessarily reflect the views of the authors' firms or clients.

Is Deferred Interest on a PIK Debt Instrument Deductible?

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When a debt instrument is issued or deemed to be issued after a significant modification, as defined in Treasury Regulation Section 1.1001-3,[1] the issuer of the debt instrument should consider whether the debt instrument will be considered to be an Applicable High Yield Discount Obligation (AHYDO). Section 163(e)(5) may permanently disallow all or a portion of a corporate AHYDO issuer's interest deduction related to the AHYDO's Original Issue Discount (OID, or deferred interest related to a debt obligation).

The AHYDO rules are generally designed to restrict the allowance of a tax deduction when a debt instrument issued by a corporation bears interest at a high rate, if a substantial amount of that interest comes in the form of OID that is not paid for many years after it accrues. This article discusses the potential income tax consequences to a corporate issuer of an AHYDO. Specifically, this article discusses the AHYDO rules and potential ways to avoid having a debt instrument classified as an AHYDO.

What is an AHYDO?

As defined in Section 163(i)(1), an AYHDO is a debt that: (1) has a maturity date that is *more than five years* after the issue date; (2) has a yield to maturity that *equals or exceeds the Applicable Federal Rate (AFR)*[2] for the month in which the debt is issued plus five percentage points; and (3) is issued with "*Significant OID.*"

OID is the excess of the stated redemption price at maturity over the issue price of a debt instrument.[3] A debt instrument is treated as having Significant OID if, as of the end of the first accrual period following the fifth anniversary of issuance (or as of the end of any subsequent accrual period), an amount greater than one year's worth of OID (the yield to maturity multiplied by the issue price of the debt instrument) can remain unpaid.[4] Stated differently, "Significant OID" exists whenever a borrower is *permitted* to defer the payment of more than one year's interest over the course of the first five years of the debt instrument, *even if the borrower does not actually elect to do so*. For this purpose, each payment under the instrument is assumed to be paid on the last day permitted under the terms of the instrument. Thus the AHYDO rules are aimed at debt obligations where the payment of a significant amount of interest can be deferred.

AHYDO Interest Deductibility

A corporate issuer of an AHYDO may not deduct OID on an AHYDO to the extent of the lesser of (1) the total OID on the AHYDO or (2) the portion of the total return (*i.e.*, OID plus qualified stated interest) on the AHYDO that exceeds the portion of the total return attributable to a yield to maturity equal to the AFR for the month the AHYDO is issued plus six percentage points (the "disqualified portion").[5]

Generally, when a corporation issues a debt instrument subject to the AHYDO rules under Section 163(e)(5), the disqualified portion of the OID is considered to be a distribution akin to a dividend, thus rendering that portion nondeductible for tax purposes. As discussed earlier, the corporation must defer the deduction for the remaining amount of OID until it is actually paid in cash or property. Such a result may not have been contemplated at the time the debt instrument was entered into, and can have a drastic result on an issuer's taxable income.

Risks with PIK Toggle Features in Debt Instruments

A "Payment in Kind ("PIK") Toggle" debt instrument is one that provides the borrower with a choice as to how to pay accrued interest for each interest period during the first several years of the debt instrument. For instance, a PIK Toggle debt instrument may allow the issuer to: (1) pay interest completely in cash, (2) pay the interest completely "in kind" by simply adding it to the principal amount (or by issuing new debt instruments having a principal amount equal to the interest so paid), or (3) pay half of the interest in cash and half "in kind."'

Use of PIK toggles declined following the credit crisis in 2008, but resurged in 2012 and have been continuously increasing in the years since. As debt with PIK toggles continue to enter into the market, it is important to understand the effect they can have on the application of the AHYDO rules.

1 See Sara Neff, "Tax Consequences of Modifying a Debt Instrument," *AIRA Journal*, Vol. 30 No. 4 (2016).

2 Section 1274(d) provides that the AFR is the lowest interest rate in effect for any of the three preceding calendar months determined based on average interest rate on outstanding marketable obligations of the United States. The AFR is determined for short-term (less than 3 years), mid-term (3 to 9 years) and long-term (over 9 year) debt instruments.

3 Section. 1273(a)(1).

4 Section 163(i)(2) and (3).

5 Section 163(e)(5)(A)(i).

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Because interest on a PIK Toggle debt instrument is not mandatorily payable on at least an annual basis, the debt instrument has OID, and if the AHYDO rules discussed above are met, the deductibility of the OID may be deferred or denied as a result.

Catch-up Clauses

A carefully drafted PIK debt instrument may provide a provision that acts as a safety net to insure there is no "Significant OID" and thus render the AHYDO rules inapplicable. Such a provision is typically referred to as a PIK "catch-up" or PIK "savings" clause. Such a clause will, in effect, alter the terms of the debt instrument and provide for a catch-up payment around the fifth anniversary of the original issuance of the debt instrument in an amount sufficient to decrease the accrued but unpaid OID to less than one year's worth of interest. After such date, all interest must be paid on a current basis.

Trap for the Unwary – The PIK Toggle Effect on Catch-up Clauses

In order for a catch-up payment provision to be respected, and provide an escape from application of the AHYDO rules, two key conditions must be addressed. The amount of the payment must reduce the amount of accrued interest to no more than one year's worth of interest under the terms of the debt instrument. Additionally, the payment must be made in cash, though for purposes of the AHDYO rules, property other than cash is considered cash. Further, the payment must be made by the end of the first accrual period ending after the fifth anniversary of the issuance of the debt instrument. Note that the accrual period may be different depending on the type of debt instrument. Lastly, there must be an unconditional obligation to make such payment and a reasonable expectation the borrower will be able to make such payment.

The calculation of the amount of an AHYDO catch-up payment may be calculated with relative certainty in the case of PIK debt that does not have the "toggle" feature discussed above as there is no cash component in addition to PIK component. However, in the case of PIK Toggle debt, the elective nature of the PIK payment raises significant questions and concern as the calculation of the amount of the catch-up payment is not addressed in the applicable sections of the Internal Revenue Code or Treasury Regulations. This is further complicated by the fact that, (1) as discussed above, OID is "Significant" if under the terms of the debt, the amount of accrued but unpaid OID at the end of an accrual period that occurs more than five years after the issuance of the debt could be greater than one year's worth of yield, calculated based on the yield to maturity of the debt, and (2) the mechanisms customarily used for calculating yield to maturity differ based on whether payments are made in cash or in-kind. Marrying the differing concepts in order to calculate the required catch-up amount will often prove to be a difficult task in a debt instrument with PIK Toggle features, and the risk of miscalculation is quite high.

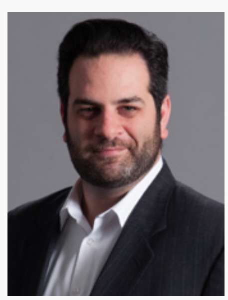
Trap for the Unwary – Beware of Senior Debt Covenants' Effect on Catch-up Clauses

Although a debt instrument might contain a catch-up provision which appears on its face to meet all of the outlined requirements above, there may be a further uncontrollable restriction on the borrower's actual ability to make the catch-up payment that runs afoul of the *unconditional obligation* to pay requirement. For instance, senior creditors may restrict the borrower's ability to make an AHYDO catch-up payment or restrict the subordinated creditors' rights if the payment is not made. When such senior debt covenants are involved, it is particularly important to look at all the facts and circumstances to determine the conditionality of the catch-up payment.

Conclusion

Corporate taxpayers should carefully determine if newly issued debt and significant debt modifications may result in application of the AHYDO rules and limit the ability to deduct OID. Due to the implications of a debt instrument being subjected to the AHYDO rules, the complexity of analyzing PIK Toggle features and the facts and circumstances surrounding catch-up provisions, it is important that a tax practitioner always be involved in reviewing PIK debt instruments before they are issued or modified. However, the easiest and most direct way to avoid the AHYDO rules is to ensure that a PIK debt instrument matures in five or less years.

ABOUT THE AUTHOR



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What to Do if You Suspect Your EB-5 Project is in Trouble

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The EB-5 Immigrant Investor Program created as part of the Immigration Act of 1990, allows foreigners to obtain permanent US residency if they invest at least $500,000 in a business venture in a targeted employment area and create at least 10 new jobs per investor. When equity capital for real estate development became scarce after the financial meltdown of 2008/2009, and more investors from mainland China became interested in obtaining U.S. residency, the Program expanded from a few thousand applications per year to current levels of well over 10,000 applications per year. Since 2008, the number of EB-5 visas sought, and hence the use of EB-5 capital, has skyrocketed with over $20 billion flowing in to the U.S. economy over the last three years. EB-5 capital has become an attractive capital source providing extraordinary flexibility and favorable terms, especially to finance commercial real estate projects.

But as the program has exploded in popularity, some very bad actors have gotten their hands on money for projects that were but a façade for stealing the money or for projects that never made true economic sense. The EB-5 investment community has now become more aware of the need for vigilance in monitoring EB-5 investments and, if necessary, taking steps to protect EB-5 investors from loss of their visas and loss of their investment.

Importance of Regular Monitoring by EB-5 Managers and Investors

To allow for timely action to protect their EB-5 investment funds and projects,[1] it is critical that EB-5 managers[2] and investors stay informed of the status of their EB-5 projects. In order to qualify for approval of their I-829 petitions[3] to remove conditions to their residence, EB-5 investors must demonstrate that the projects in which they invested were completed and, in some cases, that those projects are operating in accordance with projections. If the EB-5 manager or investors discover signs that their EB-5 project may be experiencing financial or other difficulties that could

1 The term "EB-5 investment fund" is used to refer to the "new commercial enterprise (NCE)" in which EB-5 investors make their investment. An EB-5 investment fund may be either a limited partnership or a limited liability company. "EB-5 project" refers to the project to be completed and/or operated by the "job creating entity" established via an EB-5 investment fund.

2 The term "EB-5 manager" (of EB-5 investment funds) refers to the parties designated as the general partner of the limited partnership or the manager(s) of the limited liability company.

3 "I-829 petition" refers to Form I-829 of the Department of Homeland Security, U.S. Citizenship and Immigration Services (USCIS), "Petition by Entrepreneur to Remove Conditions on Permanent Resident Status."

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prevent completion or operation in accordance with the original business plan, the manager, investors or their representatives need to evaluate what action(s) might be needed to save the project, so the EB-5 investors will ultimately qualify for approval of their I-829 petitions. The manager and/or investors are in a far better position to take protective actions before problems with an EB-5 project result in litigation, foreclosure, or SEC enforcement actions, although it may still be possible to take such measures after one of those events occurs.

Both managers and investors in EB-5 investment funds should continuously monitor and evaluate the progress of their EB-5 projects, collecting documentation of transfers of EB-5 funds, payments of project expenditures, and other financial records that are required with the I-829 petition. Unwillingness to provide such documentation, which is mostly generated in the normal course of business, can be a red flag to investors, indicating that something is wrong. The manager of each EB-5 investment fund is the primary party responsible for monitoring the fund's investment in the project. However, in cases where the manager is affiliated with the EB-5 project developer or is not fulfilling its (the manager's) obligation to properly supervise and monitor the project, the EB-5 investors should have their own independent representatives monitor the project and evaluate if and when protective actions are necessary to protect investors.

The manager of an EB-5 investment fund (or third party service provider where the manager is affiliated with the developer) should provide regular reports (preferably on a quarterly basis) to the EB-5 investors regarding the status of construction and financing of the project, payments made to the EB-5 investment fund and whether or not the EB-5 project is in compliance with the terms of the investment or loan agreement governing the investment made by the EB-5 investment fund into the project. EB-5 investors should insist that the manager of their EB-5 investment fund make these periodic reports. If EB-5 investors do not receive these reports, they should engage an independent representative to meet with the manager, review the project and advise the investors directly regarding the status of the project and any problems discovered in the review.

Early Signs an EB-5 Project May Be in Trouble

Managers and investors in EB-5 investment funds should be aware of warning signs that their EB-5 project may be experiencing difficulty. Such warning signs include:

- Failure of the EB-5 project developer to deliver regular reports to the EB-5 investment fund manager on the status of financing, construction and/or operation of the project
- Failure of the EB-5 project developer to regularly provide documentation of expenditures and the use of EB-5 funds
- Failure of the EB-5 project developer to obtain all necessary financing to commence or complete the project
- Failure to make payments on an EB-5 loan or equity investment, or on any other financing obtained by the EB-5 project
- Failure to deliver required financial and other reports to EB-5 lender and/or EB-5 investors
- Receipt of notice of default from the senior lender to the EB-5 project
- Receipt of information that the EB-5 project is not paying its contractors
- Receipt of notice that litigation has been filed against the EB-5 project or developer
- Evidence that the EB-5 project has not commenced or has ceased construction
- Failure of the EB-5 project to meet the dates specified in the project construction schedule

The fact that one or more of these events has occurred may not necessarily indicate that the EB-5 project is in distress, but it signals there may be a problem and further investigation should be conducted to determine if there is a problem.

Managers of EB-5 Investment Funds May Need to Hire a Monitor

When the manager of an EB-5 investment fund suspects the EB-5 project may be in trouble, the manager of the investment fund should hire an experienced construction monitor and/or accountant to conduct a thorough review of the status of the project. An experienced construction monitor and/or accountant may take the following steps to evaluate the status of the EB-5 project:

- Interview the developer, architect and engineer for the project
- Obtain copies of the EB-5 project entity financial statements
- Visit the office where the EB-5 project's books and records are maintained, to conduct a review of the books and records including the general ledger, invoices and other financial records of the project
- Review all material cash transfers of the EB-5 project entities to determine if improper payments are being made
- Conduct a site visit to assess construction activity and compare it to the project construction schedule and project construction reports
- Conduct a public records search to identify all liens filed against the EB-5 project property
- Review zoning approvals and building permits for the EB-5 project
- Assess the market valuation of the EB-5 project with local real estate brokers

Depending upon the results of the review and evaluation, the construction monitor and/or accountant will present a report to the manager regarding the status of the EB-5 project and any problems that have been discovered. The construction monitor and/or accountant will also be able to assist the manager in determining the severity of the problem and evaluating potential solutions to the problem. The manager and its consultants should review the options available for completing the project and determine which of those options should be pursued.

EB-5 Investors May Need to Hire Their Own Representatives

As limited partners or members of an EB-5 investment fund, EB-5 investors typically have rights to review the books and records of the investment fund and require that the manager of the fund fulfill its duties to monitor the project and protect the interests of the EB-5 investment fund and the EB-5 investors. EB-5 investors may exercise these rights either individually or as a group.

If EB-5 investors are concerned that the manager of their EB-5 investment fund is not fulfilling its obligations, the investors or their agents should hire their own experienced construction monitor and/or accountant to act as their representative and report directly to the EB-5 investors.

EB-5 investors who are concerned that the manager of their investment fund is not fulfilling its duties should engage an attorney to: (a) act as representative of one or more of the EB-5 investors; (b) review the books and records of the EB-5 investment fund itself and the EB-5 project entities; and (c) meet with the manager of the EB-5 investment fund regarding the steps that should be taken to assure adequate and necessary monitoring and reporting.

The attorney for the EB-5 investors will undertake the following review and analysis of the protective actions that may be taken on behalf of the EB-5 investors:

- Review the partnership agreement or operating agreement of the EB-5 investment fund to determine the specific rights of the EB-5 investors to take actions under the terms of the partnership agreement or operating agreement
- Review the communications, construction reports and financial statements that have been received by the EB-5 investors
- Review the books and records maintained by the manager of the EB-5 investment fund, including notices, reports and financial statements received by the manager from the EB-5 project entity or developer
- Review the financial statements of the EB-5 investment fund
- Review the project financing documents between the EB-5 investment fund and the EB-5 project entity (loan agreement, pledges, guaranties, intercreditor agreements, etc.) to determine the rights of the EB-5 investment fund
- Interview the manager of the EB-5 investment fund and the EB-5 project developer
- Review the adequacy of the documentation necessary to meet annual USCIS reporting requirements and the I-829 requirements
- Evaluate the status of the EB-5 project to determine additional steps necessary to be taken to protect the EB-5 investors (both with respect to their visa petitions and their financial investment) and their investment in the EB-5 project

The steps listed above generally take about two to four weeks, but may take additional time if the manager does not cooperate. If the manager of the EB-5 investment fund is not cooperative, the attorney may recommend seeking a court order compelling the manager to turn over the necessary books and records to the attorney for the EB-5 investors. Upon completing the review, the attorney should prepare a report of the findings of the review and distribute it to the EB-5 investors. The report should include an analysis of the actions recommended by the attorney to protect the interests of the EB-5 investors. These recommendations could include: (a) implementing new reporting requirements by the manager of the EB-5 investment fund or by the EB-5 project entity; (b) requiring the manager to hire an independent construction monitor or loan servicer; or (c) seeking further court orders if necessary for the protection of the EB-5 investors. If the attorney discovers problems with the EB-5 project itself, the report should include a summary of the problems and discussion of the options available to the EB-5 investors to save the EB-5 project.

Implementing a Plan for Monitoring and Reporting on EB-5 Projects

The manager or investors in an EB-5 investment fund should implement a systematic plan for continuous monitoring and reporting on the status of the EB-5 project. Every EB-5 investment fund should have a regular process in place for monitoring its investment in the EB-5 project. This is often referred to as EB-5 compliance, but can also be thought of as ongoing due diligence. These processes are similar to those that would be used by any other private lender or institutional investor in a construction project or business, with the additional focus on job creation in addition to the financial health of the EB-5 project.

The following are some of the essential components of an effective plan for monitoring the EB-5 project:

- Document all money deposited into the EB-5 investment fund escrow account, all money disbursed out of escrow to the EB-5 investment fund, and all money disbursed to the job creating entity for use in financing the EB-5 project, in order to demonstrate an unbroken chain in the path of funds from the EB-5 investor to the job creating entity
- Conduct regular inspections of the project and review disbursement requests, and, if appropriate, hire a construction monitor to make the inspections and/or an independent loan servicer to receive reports and payments made by the EB-5 project entity to the EB-5 investment fund

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- Require that requests for disbursement of EB-5 proceeds include detailed descriptions of the use of proceeds of each advance, including contractor invoices, architect or engineer certification, lien releases, and other documents (i.e., a draw package or payment application)
- Require regular construction reports and financial statements from the EB-5 project developer
- Require that the senior lender provide copies of notices to the New Commercial Enterprise or "NCE" concurrently with delivery to the developer
- Regularly communicate with the EB-5 project developer to discover as early as possible if problems are developing and, if possible, thereafter work with the developer to help resolve issues before they become a crisis

Responding to SEC Enforcement Action against an EB-5 Manager

If an SEC enforcement action is filed against a manager of an EB-5 investment fund, EB-5 investors should engage their own legal counsel to participate as interested parties in the action.

The SEC is aware of the issues facing EB-5 investors whose investment funds have become the subject of fraud enforcement actions, and will work with legal counsel for EB-5 investors to assist them, if possible, to save the EB-5 project and preserve eligibility for permanent visas. Nonetheless, the SEC does not represent the investors and has limited tools at its disposal to help them. The legal and financial representatives of the EB-5 investors can assist them in the following actions:

- Communicate with the SEC, receiver (if appointed by the Court) and USCIS regarding EB-5 investors' desire to analyze viability of completing the EB-5 project
- Hire (or coordinate with the receiver to hire) an experienced construction monitor/accountant to conduct the investigation described above and determine if the EB-5 project can be completed
- Determine what additional capital sources would be required to complete the EB-5 project and assist in the transactions required to bring in those capital sources
- Determine what changes in the business plan would be required to accept the additional capital and work with the USCIS to preserve the eligibility of the EB-5 investors in the project under the new capital structure

Conclusion

EB-5 managers and investors can and must take appropriate steps to monitor their EB-5 investments in order to timely discover any problems that arise, and take action to help EB-5 investors retain eligibility for their permanent visas and receive a return of their capital. Managers should implement a process for regular monitoring of the EB-5 project status and reporting of any problems that develop. Managers should also provide regular reports to EB-5 investors so they know their investment is being properly monitored. If managers do not fulfill their duties, EB-5 investors should hire their own representatives to investigate the status of the EB-5 project and implement a better monitoring process in the future. If necessary, the manager or EB-5 investors need to be prepared to evaluate options to save their EB-5 project if it experiences financial or other problems.

ABOUT THE AUTHORS

Jeffrey E. Brandlin, CIRA
founded **Brandlin & Associates** in 1980. During his career, Jeff has pursued numerous financial frauds, accounting malpractices and trust fund embezzlements including SEC enforcement actions pertaining to the EB-5 Program. In addition, Jeff and his team have restructured and rehabilitated more than $10 billion of real estate projects over the last three credit cycles. Jeff is a Certified Insolvency and Restructuring Advisor (CIRA) and is Certified in Financial Forensics (CFF) by the American Institute of CPAs and currently serves on the board of the National Association of Federal Equity Receivers (NAFER)

Catherine D. Holmes, Esq.
is Chair of the **JMBM Investment Capital Law Group**, where she has practiced for over 35 years. In the last five years, she has represented over 100 real estate developers to obtain financing through the EB-5 program for the development of hotels, multi-family and mixed use developments. She has also represented private investment fund managers, registered securities broker-dealers and investment advisers on securities offerings, business transactions and regulatory compliance issues. For the last two years, she has been named as one of the top 25 securities lawyers in the country by EB5 Investors magazine.

Daniel B. Lundy, Esq.
is a Partner and a member of the EB-5 practice of **Klasko Immigration Law Partners, LLP**. Mr. Lundy leads the Regional Center/Developer and EB-5 Compliance practice areas, and represents developers and others who seek to use foreign investment funds under the EB-5 program to fund their projects, either through the formation of a Regional Center or by joining with an existing Regional Center. For the last two years, he has been named as one of the top 25 immigration lawyers in the country by EB5 Investors magazine.

Members in the News & on the Move

SONEET R. KAPILA, CIRA
Partner, KapilaMukamal, LLP

KAPILAMUKAMAL RECEIVES M&A ADVISOR'S TURNAROUND AWARD

KapilaMukamal is pleased to announce that the firm is a recipient of the M&A Advisor's 11th Annual Turnaround Award in the Sector Award Category - Consumer Discretionary Deal of the Year (Over $25MM to $50MM) in the Chapter 11 Case of Simply Fashion Stores, Ltd.

In April of 2015, Soneet Kapila was appointed as Chief Restructuring Officer and KapilaMukamal served as Restructuring Advisors to the Debtors, Adinath Corp. and Simply Fashion Stores, Ltd. which operated over 240 retail stores in multiple states. Over the course of many months, Kapila and the KM team provided practical hands-on guidance in the matters of store closings, employee disputes, multi-state tax issues, and other complex negotiations.

"The award winners represent the best of the distressed investing and reorganization industry in 2016 and earned these honors by standing out in a group of very impressive candidates," said David Fergusson, Co-CEO and President of The M&A Advisor.

The nominations, representing over 300 participating companies, were judged by an independent jury of industry experts. Annually, the M&A Advisor announces the winners of its Turnaround Awards in each of the categories of Restructuring of the Year, Transaction of the Year, Refinancing of the Year, Sector Deal of the Year, Firm of the Year, Turnaround Product/Service of the Year and Professional of the Year. The awards will be presented at a Black Tie Gala on Thursday, March 23, 2017 at the Colony Hotel, Palm Beach, FL.

AIRA congratulates Mr. Kapila, who has long been an active member of AIRA, serves as a current Director, and is a past President and Chairman.

SUBMIT YOUR ANNOUNCEMENT FOR THIS SECTION—AIRA members and their representatives are invited to submit material for the Members in the News/on the Move section of *AIRA Journal* at any time. AIRA Journal is published quarterly and announcements will be included as space allows in each edition. Please send notices of about 150 words and photos (900kb or larger size) to Valda Newton vnewton@aira.org.

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CLUB 10

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