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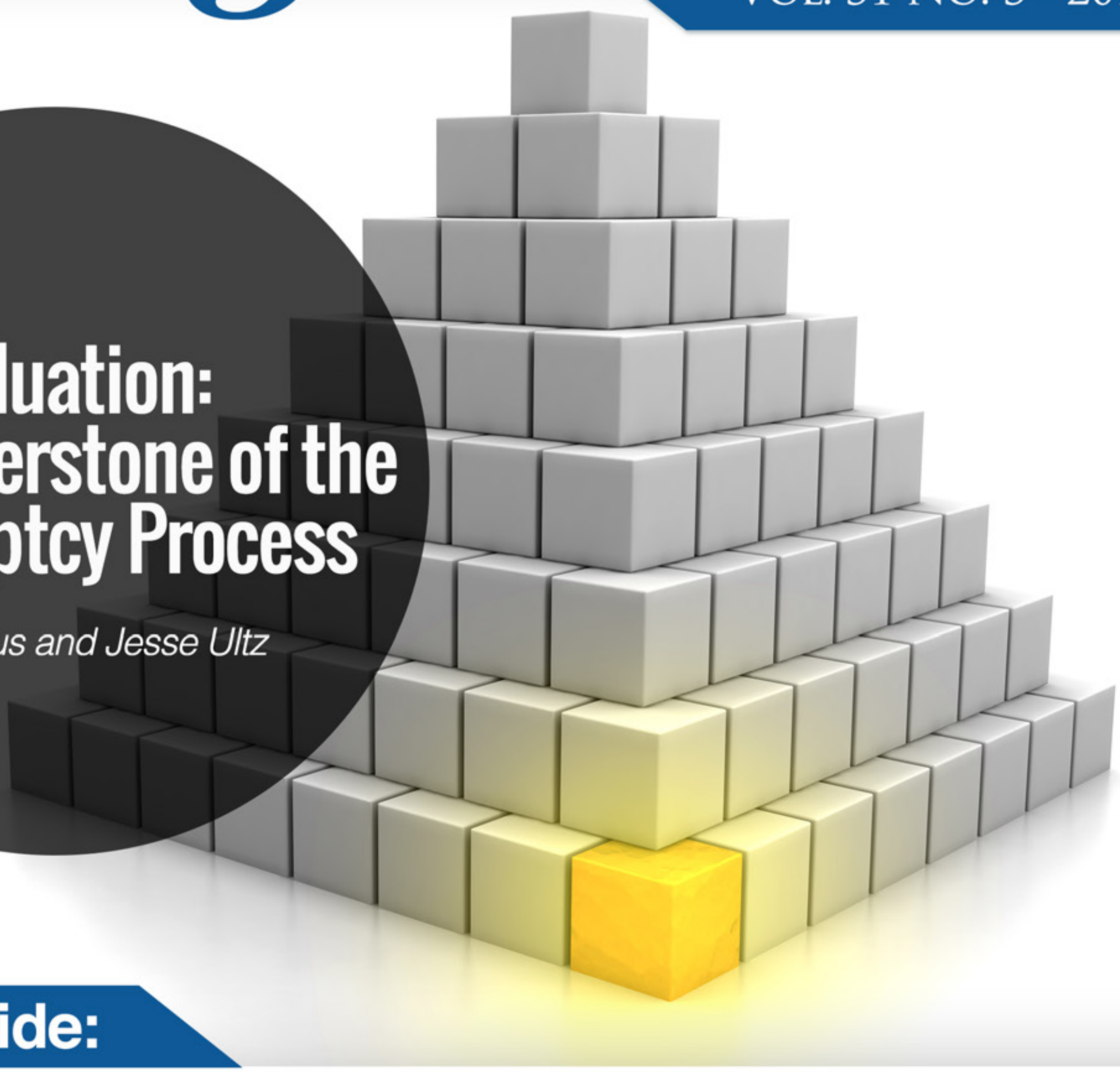

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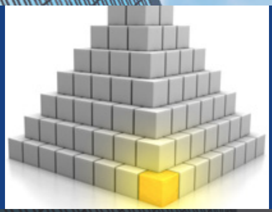
6 
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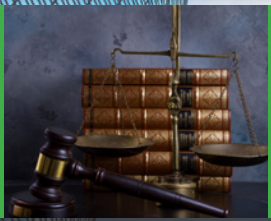
12 
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From the
Executive Director's Desk

THOMAS MORROW, CIRA
AIRA

Dear AIRA Members,

With this issue we are starting the one year presidency of Joel Waite. Joel took over in June after Angela Shortall finished her extended term. As you may recall Angela was drafted into service early, when I left my post as President to take over for Grant Newton as the Executive Director. I want to thank Angela for stepping up and helping AIRA through this important leadership transition.

AIRA has a long tradition of service to its membership. With its roots going back to 1979, AIRA is the oldest organization dedicated to serving the educational needs of accounting and financial advisor professionals in the reorganization space. We will soon be awarding the 2,000th CIRA certificate and many practitioners remain active to this day.

Much of AIRA's success through the years is a result of its very active board members. AIRA board membership is not simply an honorary posting. We currently have 36 board members and all are active supporters of the organization. Board members volunteer their time to help plan educational programs at our conferences. Board members provide sponsorships that help us to continue to offer exceptional educational programming. Board members actively participate in the governance of the organization at three board meetings each year. I want to take a moment to thank all of the board members for their support in my transition as Executive Director; they have made it far easier than I thought it would be.

AIRA faces a challenging environment going forward. Our member firms are facing increasing margin pressure causing them to closely review sponsorships and attendance at educational events. We understand this and are dedicated to continuing to offer high quality, focused education at reasonable costs. We do this by leveraging the volunteers on our planning committees. We also do this by asking board members to provide training rooms to hold our classes. We look at every expense and try to provide the educational programming at the lowest cost possible without compromising the quality of the educational material.

Thank you again for your support. I know many of you are first introduced to AIRA through the CIRA program. I hope that you will keep encouraging your colleagues to complete the certification process. And I hope that you will continue your education at our conferences throughout the year: the Restructuring Conference with NYIC in January; VALCON (next in May 2018), held with the ABI; AIRA's Annual Conference in June; Dallas Energy Summit hosted with CFA in September; breakfast program at the NCBJ with the American College of Bankruptcy; and the Advanced Restructuring and POR Conference in November. I look forward to seeing many of you at these events.

A Letter from
AIRA's President

JOEL WAITE
Young Conaway Stargatt & Taylor LLP

Greetings fellow AIRA members. At the conclusion of the 2017 Annual Conference in June, I began my term as President of the AIRA, following in the shoes of Angela Shortall. Thank you, Angela, for all of your dedication and hard work on behalf of our organization. I have had the privilege over the past 10+ years to serve with the many fine and dedicated professionals that make up the AIRA Board of Directors. I look forward to working with the Board, our executive director, Tom Morrow, the rest of the AIRA staff and our members during my term as President, as I strive to continue and build upon the great work of Angela and the others that have preceded me in this position

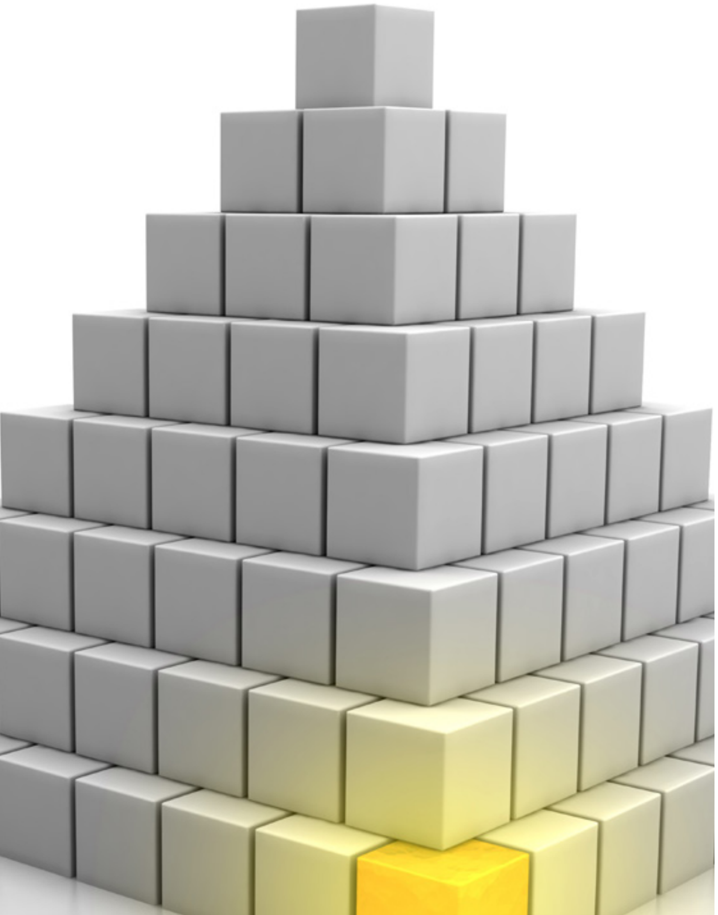
I enjoyed seeing many of you recently at the 16th Annual Advanced Restructuring and Plan of Reorganization Conference ("NY POR"), which was held at the Union League Club in New York City on Monday, November 13, 2017. Thanks to the NY POR Co-Chairs, Brian Ryniker, CIRA (CBIZ MHM, LLC) and Michael Lastowski (Duane Morris) and the entire planning committee for putting together a schedule of interesting and informative panels, which included participation by several bankruptcy judges from the 2nd and 3rd Circuits. And, congratulations to, Judge Elizabeth S. Stong (Bankr. EDNY), who was presented with the Judicial Service Award, at the reception following the education sessions, in recognition of her many contributions to the bar and restructuring practice.

While it is still more than 6 months away, I want to put in a save-the-date plug now for our 2018 Annual Conference, which will be held in Nashville, TN at the Loews Vanderbilt Hotel on June 13-16, 2018. We have assembled a planning committee composed of a very talented, energetic and dynamic group of restructuring professionals to help plan the annual conference. The planning committee is being co-chaired by Lawrence R. Ahern III (Brown & Ahern), Jennifer Meyerowitz (GCG) and Robert H. Barnett (Conway MacKenzie). We are also very fortunate to have Judge Randal S. Mashburn (Bankr. M.D. TN) and Judge Shelley D. Rucker (Bankr. E.D. TN) assisting us as Judicial Co-Chairs. At our kick-off meeting of the planning committee in Nashville several weeks ago, our biggest challenge was that we had more great ideas for panel topics than we have time slots available. It's a good problem to have. We are also planning some fun excursions and networking opportunities for the Nashville conference. More information on the 2018 Annual Conference will be available on the AIRA website in early 2018; but for now, mark your calendars and plan to join us in Nashville next June for what is going to be a fantastic conference in a fun city.

Finally, a word about the AIRA Journal. I hope you find the articles included in each issue of AIRA Journal interesting and helpful to your practice. That is certainly our goal. To accomplish that goal we are always looking for great articles on interesting topics from our members to include in future editions. If you have recently argued or briefed a novel or interesting issue, spoken on an interesting subject at a conference, or are otherwise familiar with a topic you think would be of interest to your fellow AIRA members, please consider writing an article on that topic and submitting it to AIRA Journal. Information about how to submit ideas and articles is available on the AIRA website at https://www.aira.org/journal.

I hope to see you at an AIRA event soon.

Valuation: The Cornerstone of the Bankruptcy Process



JEFF RISIUS AND JESSE ULTZ
Stout

From the initial bankruptcy filing through the eventual emergence, valuation plays a critical role in multiple scenarios.

The number of business bankruptcies is highly cyclical, tied closely to the health of the overall economy. Over the past 15 years, business bankruptcy filings in the U.S. have seen some significant peaks and valleys (Figure 1). After bottoming out in 2006, business bankruptcies more than tripled by the peak in 2009 during the Great Recession. However, since 2009, bankruptcies have declined in every single year, as the economy has experienced a period of sustained growth in an extremely low interest rate environment.

A bankruptcy case begins with the filing of a petition, which can be either voluntary or involuntary. Depending on the status of the filing company (i.e., the debtor), the petition is filed under either Chapter 7 or Chapter 11 of the Bankruptcy Code (the "Code"). A company typically elects to file for bankruptcy under Chapter 7 of the Code when continued business operations cannot be supported by the income the company is generating. If a company elects to file a Chapter 7 bankruptcy petition, a trustee is appointed, and the debtor then discontinues its operations and all assets are liquidated

FIGURE 1 BUSINESS BANKRUPTCY FILING TRENDS[1]

1 American Bankruptcy Institute, Quarterly Business Bankruptcy Filings for 1994-2015. http://s3.amazonaws.com/abi-org/Newsroom/Bankruptcy_Statistics/QUARTERLY-BUSINESS-1980-PRESENT.pdf

on an orderly basis. The proceeds from this liquidation are then distributed to the claimholders and creditors in order of priority. If a company chooses to file bankruptcy under Chapter 11 of the Code, then the debtor is allowed to attempt to reorganize the business and continue operations. The filing of a Chapter 11 bankruptcy creates an "estate," and all of the debtor's assets become the property of that estate. The filing company is permitted to retain and use the property of the estate as a "debtor in possession."

Throughout the entire bankruptcy process, the practical and strategic implications of valuation play key roles. Every constituent to the bankruptcy will make decisions based on the value of the debtor and its assets. There are specific situations whereby valuation issues are of critical importance – from the filing of a petition under Chapter 11 through the subject debtor's eventual emergence. Some of the most critical areas include: adequate protection; claims determination; plan confirmation; and recovery actions.

Adequate Protection

When a company files for bankruptcy, the bankruptcy petition automatically enjoins all creditor activity and operates as a stay. This automatic stay prevents creditors with liens from enforcing them. In order for a secured creditor to repossess its collateral, the creditor must bring forward a motion for relief from the stay. Under Section 362(d)(2) of the Code, the bankruptcy court will grant relief from the stay if: (i) the debtor does not have equity in the property; and (ii) the property is not necessary to an effective reorganization. In deciding whether to give the creditor relief from the automatic stay, the court must weigh the danger to interests of creditors against the necessity of the property to the debtor's reorganization. While the second item is somewhat subjective and up to the decision of the judge (i.e., how necessary the property is), the determination of whether the debtor has equity in the property is clearly an area where a valuation expert can provide testimony as to the value of the asset relative to the associated lien.

If the previous argument fails, the creditor can still ask for relief by arguing that it is not adequately protected. Under Section 362(d)(1) of the Code, the lack of adequate protection for a creditor's property interest is cause for granting relief from the automatic stay. In order to assess this, the current value of the collateral securing a creditor's lien must be determined by a valuation expert. In addition to determining the current value of the collateral, it is important to determine the extent to which the collateral has recently declined in value or will likely decline in value in the future. In addressing the valuation issues in this regard, a going concern premise of value, as opposed to a liquidation premise of value, is typically assumed, unless the business is not expected to reorganize.[2] Depending on the facts and circumstances of each situation, all traditional valuation methods (i.e., the income, market, and asset approaches) should be considered.

Once the applicable assets have been valued, the value of the collateral in excess of the creditor's lien can be determined. This excess value is sometimes called an equity cushion. However, this term may be misleading, as the creditor's position does not entitle it to any portion of value above and beyond the amount of the lien. In addition, it may not truly be an equity cushion, as there could still be junior creditors that have a further claim on the asset(s). Thus, it may be more appropriate to think of this excess value as a value cushion rather than an equity cushion. Although the determination as to whether a creditor is adequately protected is largely based on the facts and circumstances of each case, the following general guidelines are often cited in court decisions:

- If the value cushion is greater than 20%, the creditor's lien is adequately protected.
- If the value cushion is between 11% and 20%, the determination of adequate protection will be based on the specific facts and circumstances of the case (e.g., trends in value indications and projections regarding the subject market).
- If the value cushion is below 11%, the creditor's lien is not adequately protected.

In a situation where the debtor's collateral does not adequately protect the creditor's lien, the debtor may provide adequate protection by other means. One option is for the debtor to make periodic payments to the creditor equal to the expected depreciation in value of the collateral securing the creditor's position. Alternatively, the debtor may grant the creditor an additional lien on other unencumbered property.

The determination of the existence of adequate protection, as well as the remedy if adequate protection does not exist, is an area where a valuation expert is critical to the process for the various stakeholders in a bankruptcy.

Claims Determination

In the event a creditor's secured claim is not adequately protected and lacks a value cushion (i.e., it is undersecured), Section 506(a) of the Code creates a process of bifurcating the total allowed claim into a secured portion and an unsecured portion. Specifically, when the value of the collateral is not sufficient to pay the entire secured claim, a creditor is seen as having two claims: (i) a secured claim to the extent of the collateral value; and (ii) an unsecured claim to the extent of the claim that exceeds the collateral value.

As an alternative to the bifurcation of claims, a creditor may choose to have its entire claim treated as a secured claim by making an election under Section 1111(b) of the Code. If a Section 1111(b) election is made, the creditor forgoes any recourse that it may have as an unsecured creditor for the value of its claim in excess of the value of the collateral, and

2 Newton, Grant W., Paul N. Shields, and James F. Hart, Business Valuation in Bankruptcy: A Nonauthoritative Guide, American Institute of Certified Public Accountants, 2002.

Continued from p.7

the creditor is treated as holding a secured claim for the full allowed claim. In other words, under Section 1111(b), an undersecured creditor may elect to have its entire claim treated as a nonrecourse secured claim, thereby foregoing any unsecured deficiency claim. It should be noted that this election is not an option for a creditor with a lien that is determined to have "inconsequential value" in a hearing under Section 506(a) of the Code. In addition, this election is not available in a situation whereby a debtor sells its assets pursuant to a Section 363 sale.Depending on the situation, it may be beneficial for either a debtor or a creditor to call a Section 506(a) hearing at some point during the bankruptcy process. The debtor may call for this hearing in order to present the court with evidence supporting the "inconsequential value" of a claim secured by collateral in order to make the Section 1111(b) election unavailable to a creditor. On the other hand, a creditor may call for this hearing to get more clarity with respect to the court's view of the value of the collateral so as to make a more informed decision with regard to whether or not to make a Section 1111(b) election. In either case, a valuation expert's opinion as to the value of the collateral at issue is a critical component of the hearing.

Section 1111(b) was originally enacted to protect the interests of secured creditors following the decision reached in *In re Pine Gate Associates, Ltd., 2 B.C.D. 1478 (Bankr. N.D. Ga. 1976)*. Pine Gate Associates (PGA) used loans from two lenders to construct an apartment complex. Both loans were nonrecourse loans and were secured by first priority mortgages on portions of the complex. In 1975, PGA filed for bankruptcy and proposed a plan of reorganization whereby PGA would make a cash payment to the two lenders for the appraised value of their collateral (portions of the apartment buildings). As such, the lenders' secured claims were limited to the appraised value of their collateral, which was found to be less than the outstanding indebtedness owed by PGA. Despite contention from the lenders, the court held that the proposed treatment of the secured claims was sufficient and approved the plan of reorganization.

In effect, the decision approved a plan of reorganization whereby "a debtor could file bankruptcy proceedings during a period when real property values were depressed, propose to repay secured indebtedness only to the extent of the value of the collateral at that time, and preserve all potential future appreciation of that property solely for the benefit of the debtor."[3] Under these terms, the secured creditor would bear all of the risk of undervaluation by the court. Section 1111(b) was, in essence, Congress' attempt to address the inequitable result that arose under the *Pine Gate* decision.

The class of creditors making a Section 1111(b) election retains full security interest in the underlying asset and has the right to receive payment in full over time for the face amount of its claims. However, not all of the possible valuation disputes go away by making such an election. Under a Section 1111(b) election, the present value of the payments to be received in satisfaction of the claim is required only to equal the value of the creditor's interest in the collateral as of the effective date of the plan of reorganization. The value of these deferred payments is largely dependent on an assessment of the appropriate market rate of return to use in the calculation of the present value equivalent of these cash flows, which often requires testimony from a valuation expert.

A creditor typically considers making a Section 1111(b) election only when it believes that the collateral is being undervalued by the debtor and the expectation is that there will be little to no value available for the unsecured creditors. During periods of depressed real estate values, secured creditors may be more inclined to make a Section 1111(b) election with the goal of maintaining a security interest in an asset that has the potential to appreciate in value, compared with bifurcating the claim and accepting an unsecured claim for that portion of the total claim in excess of the current value of the collateral. A solid understanding of the current state of the real estate market relative to its prospects and the likely ranges of impairment for the unsecured class are required in order to properly assess whether a secured creditor should make a Section 1111(b) election.

Valuation is a critical part of the claims determination process. The value of the collateral securing a claim must be determined in order for both the debtor and the creditor(s) to make the best strategic decisions with respect to the elections available during the bankruptcy process, and, ultimately, to present evidence during plan confirmation hearings.

When determining the value of specific collateral, there are sometimes two different premises of value put forth that can lead to very different conclusions. One value premise is to determine the value of the collateral by assessing the amount a creditor would receive by reselling the collateral, net of any resale costs. The alternative premise is to determine the value of the collateral by assessing the amount a debtor would have to pay to replace the collateral, in which case, the resale costs are irrelevant. Either valuation approach may be more appropriate depending on the facts and circumstances of each case. In the *Associates Commercial Corp v. Rash* decision, the Supreme Court supported the latter of the two methods. However, some ambiguities in this decision have left room for other interpretations.[4]

3 The 1111(b)(2) Election: A Primer, BANKR. DEV. J. (Vol. 13, Winter 1996), Steven R. Haydon, Steven R. Owens, Thomas J. Salerno, and Craig D. Hansen.

4 *Associates Commercial Corp v. Rash*, 117 S. Ct. 1897 (1997).

Plan Confirmation

In order for a company to emerge from Chapter 11 bankruptcy, a plan of reorganization must be submitted to the court and approved. Under Section 1121 of the Code, the debtor in possession initially has the exclusive right to file a proposed plan of reorganization, typically for a period of at least 120 days. A plan of reorganization places creditors and other interest holders into classes and states what each class will receive upon the company's emergence from bankruptcy.

Valuation is an integral part of the plan confirmation process, from the original proposal, to negotiations, through plan confirmation. In order for a debtor (or any other constituent for that matter) to propose a plan, a reorganization value of the company must be determined. The reorganization value is the starting point to determine what each of the stakeholders will receive when the debtor emerges from bankruptcy (i.e., it represents the business enterprise "pie" that needs to be divided fairly into "slices" for the various stakeholders). Various classes of secured and unsecured creditors, as well as equity holders, must review the proposed plan and vote for or against it. In order to make an informed decision, the creditors must know both the value of their collateral as well as the reorganization value of the company.

In addition, it is also necessary to value any deferred payments or securities being offered to stakeholders in satisfaction of their claims. In many bankruptcy cases, valuation issues are a significant point of contention between the various stakeholders.

A closely related topic to the valuation issues that arise during plan confirmation is whether the plan is feasible. The court does not want to approve a plan only to have the debtor re-file for bankruptcy shortly after emergence. As such, in addition to valuation arguments, the various stakeholders will also present evidence – often by the same valuation expert – as to the feasibility of the proposed plan. Significant due diligence is completed with respect to a review of management's forecasts inherent in the plan, market trends, and the debtor's historical performance versus past projections. To the extent management's projections are divergent from industry sources or consensus estimates, it is imperative for the valuation expert to be able to bridge the gap to prove that the projections, on which the plan of reorganization is based, are realistic. Further, if management has historically had a poor track record of hitting projections, increased scrutiny is likely warranted, especially in situations when the same management team performs the same budgeting/forecasting process each year and consistently misses the actual financial performance at the same rate.

Based on Section 1129 of the Code, if a dissenter votes against the plan, but the dissenter's class accepts the plan, the plan may still be confirmed assuming the "best interests" test is met. The best interests test states that the value to be received by a dissenter within an impaired class under a plan of reorganization must be equal to or greater than what the dissenter would have received if the debtor were liquidated in a Chapter 7 bankruptcy. If that test is not met, then a plan of reorganization cannot be confirmed, even if only one dissenter exists.

Another portion of Section 1129 of the Code describes the process of confirming a plan if an entire impaired class does not accept the reorganization plan (oftentimes described as a "cramdown"). If an impaired class does not accept the plan, then not only must the "best interests" test be met, but the plan must also: (i) be "fair and equitable" with respect to the dissenting class; and (ii) not "unfairly discriminate" against the dissenting class in favor of other classes. This rule requires that no class of creditors or equity holders can receive value through the reorganization until all classes that are senior have received full compensation of their claims. This concept is often referred to as the "absolute priority rule." Given the ambiguity of the relevant conditions described in this section, as well as the determination of the total value of the assets that are to be distributed, it is very important for all stakeholders to have a very good understanding of the value of the assets and the company in question in order to make informed decisions and present reasonable, well-substantiated positions at a plan confirmation hearing.

It is not unusual for proposed plans to satisfy the claims of certain classes of creditors based on deferred payments over time. In order to calculate the value of such deferred payments, it is necessary to estimate an interest rate (sometimes referred to as a "discount rate") that properly reflects the economic characteristics (e.g., investment risk, duration, and time value of money) of the deferred cash payments during the expected timeline. In "cramdown" situations, this interest rate should be estimated using market evidence of relevant interest rates and investment rates of return on comparable assets or businesses. In order for a plan to be confirmable, when the cramdown rate has been properly estimated and applied, the value of the deferred cash payments will be equivalent to the value of the claim. The Code provides no specific guidance regarding how the cramdown rate should be determined. Over the years, bankruptcy courts have accepted a variety of methods for determining cramdown rates, and this disparate treatment has resulted in more than a fair amount of controversy and litigation.[5]

A court case in which the valuation of the debtor played an important role in the plan confirmation process is *In re Bush Industries*.[6] In this case, the debtor's plan proposed to cancel pre-petition equity holders, as the debtor concluded that the reorganization value of the company was below the equity hurdle. The equity committee asserted that the value of the debtor was greater than the amount of

5 Reference should be made to the decision in *Till v. SCS Credit Corp.*, 541 US 465, (2004) for a suggested framework to apply in estimating an appropriate cramdown rate, often referred to as a "formula approach." It is beyond the scope of this article to discuss the shortcomings of this approach.

6 *In re Bush Industries*, 315 B.R. 292 43 Bankr.Ct. Dec. 188 (2004).

Continued from p.9

outstanding claims, thus the equity of the company had value. Both the debtor and the creditor hired valuation experts to testify on their behalf. After reviewing each of the experts' testimony, the court ruled that the value of the company did not exceed the equity hurdle, and thus the pre-petition equity could have no value upon emergence.

In addition to the valuations performed by the experts in *Bush*, other market evidence involving arm's length transactions was cited by the court in support of its opinion. For example, several creditors liquidated their pre-petition positions at a discount, which implied that they accepted less than face value while holding a claim that was senior to the old equity holders. In addition, one of the secured creditors negotiated a deal with the other secured creditors whereby it was able to opt out of the plan. This creditor negotiated a deal whereby it elected not to participate in the plan and receive new stock in the reorganized company, but rather, to accept a dollar amount that was less than the face amount of its claim. These two market transactions whereby parties, which were senior to the old equity holders, accepted less than the face amount of their claims, buttressed the debtor's valuation conclusions presented at trial supporting a value below the equity hurdle.

Recovery Actions

In the ordinary course of business, solvent, well-capitalized companies can transfer property and incur obligations as they choose, assuming that they are not restricted by credit agreements. However, when a company becomes insolvent or inadequately capitalized, the creditors have a stake in the company that is recognized by the Code and state law with regard to transfers of property and incurring obligations.

A debtor is granted broad powers under Section 547(b) of the Code to recover certain transfers made prior to the filing of a bankruptcy petition. In general, transfers of property 90 days prior to a bankruptcy filing for purposes of satisfying a debt are voidable. From a creditor's perspective, transfers may be voided when the debtor enters into a transaction with the intent to defraud a creditor. The solvency of the debtor is irrelevant under such circumstances.

Under Section 548 of the Code, if constructive fraud is found, a debtor is able to void any transfer of an interest in property, or any obligation incurred by the debtor, within two years of the date of the filing of a bankruptcy petition regardless of intent. Constructive fraud occurs when the debtor receives less than reasonably equivalent value in exchange for such transfer or obligation and is insolvent on the date of such transfer or becomes insolvent as a result of such transfer or obligation.

Insolvency in the context described above is shown when the debtor:

- Has debts that exceed the value of its liabilities (i.e., balance sheet test);
- Incurred debt that was beyond its ability to pay as the debt matured (i.e., cash flow test); or
- Was engaged in a business with unreasonably small capital (i.e., capital adequacy test).The test for insolvency in a bankruptcy proceeding is virtually identical to the process undertaken for issuing a solvency opinion with respect to a contemporaneous transaction (i.e., it is effectively a retrospective solvency opinion). Under either scenario, if the company fails any of the three tests, it is determined to be insolvent.

Under the first test, if the market value of the company's assets exceeds the value of the liabilities, the balance sheet test is passed. In other words, the total enterprise value of the company must be greater than the net debt of the business in order to be deemed solvent from a balance sheet test perspective.The second test measures the ability of the company to generate cash flow sufficient to pay its debts as they mature and come due. Typically, the projections that are used to value the company under the balance sheet test are analyzed to ensure that the cash flows will be adequate to cover future principal and interest payments on the company's post-emergence debt, after meeting all the standard cash flow items such as capital expenditures and increases in working capital.

Under the third test, unreasonably small capital refers to the inability of a company to generate profits to sustain operations. This test typically includes a stress test of the proposed plan, assessing how sensitive the feasibility of the plan is to small changes in the underlying assumptions. Essentially, the purpose of this test is to measure the "margin for error" in the underlying projections. This test and the cash flow test are premised on financial results that are reasonably foreseeable as of the date of the transaction being questioned, and they should include all sources of operating funds and consider the likelihood of obtaining additional financing.

Valuation and solvency analyses are important in recovery actions in order to evaluate the issue of reasonably equivalent value and solvency in a transaction that a trustee is attempting to void. This situation may arise when a buyer of a company files for bankruptcy shortly after the purchase and attempts to void the transaction under the guise that it paid more than a reasonably equivalent value. Alternatively, a company may file for bankruptcy shortly after selling a division and may attempt to void the transaction under the guise that it received less than a reasonably equivalent value.

One case in which the creditors challenged a transaction as constructively fraudulent was *VFB LLC v. Campbell Soup Co.*[7] The transaction occurred when Campbell Soup sold its Vlasic and Swanson product lines to a new company, Vlasic Foods International, Inc. (VFI), the purchase of which was funded by a bank loan. Shares of VFI, the stock of which was publicly traded, were distributed to Campbell Soup shareholders as an in-kind dividend. Three years after the transaction, VFI filed a bankruptcy petition. In

7 *VFB LLC v. Campbell Soup Co.*, 482 F.3d 624, 48 Bankr.Ct. Dec. 3 (2007).

order to prove its case, the trustee of VFI hired valuation experts to testify that the transaction took place at more than reasonably equivalent value and that it resulted in an insolvent company. Part of VFI's position relied on claims that the financial information of VFI was misstated, and, thus, the market stock price of VFI was not reliable. The court ultimately ruled in favor of Campbell Soup. In addition to the testimony of valuation experts supporting the position that the transaction did not take place at more than reasonably equivalent value, the court pointed to the financial market's positive pricing of VFI's stock subsequent to the transaction, even after the market had knowledge through public disclosures that VFI's earnings were misstated prior to the spin-off.

Know the Valuation Issues

As summarized in this article, valuation issues permeate the entire bankruptcy process and impact each of the stakeholders along the way. The issues range from asset/collateral valuation matters, to disputes as to the value of the company as a whole, to fairness issues related to the valuation of securities and cash flow streams being proposed to settle the claims of various stakeholders.

An awareness of these issues early in the process, along with knowledge as to how valuation applies to each, will greatly assist each stakeholder throughout the bankruptcy process.

This is an updated version of an article published in the Fall 2009 issue of The Stout Journal. This article is intended for general information purposes only and is not intended to provide, and should not be used in lieu of, professional advice. The publisher assumes no liability for readers' use of the information herein and readers are encouraged to seek professional assistance with regard to specific matters. All opinions expressed in these articles are those of the authors and do not necessarily reflect the views of Stout Risius Ross, LLC or Stout Risius Ross Advisors, LLC.

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Jesse Ultz is a Managing Director in the Valuation Advisory group. He has extensive experience in the field of valuation, litigation and related expert testimony, and mergers & acquisitions. He specializes in valuation in a litigation setting; his related experience includes shareholder disputes, fraudulent conveyance matters, transaction disputes, bankruptcy related valuation litigation, and other litigation involving complex valuation issues.

The USTP's Mission as It Relates to the Corporate Restructuring Community

CLIFFORD J. WHITE III
Director, Executive Office for U.S. Trustees

Prepared Remarks for AIRA's 33rd Annual Bankruptcy & Restructuring Conference (June 7, 2017; Dallas, Texas)[1]

Introduction

Good afternoon. I am grateful for the opportunity to speak with you today about the mission of the United States Trustee Program (USTP or Program) as it relates to the corporate restructuring community. I very much respect the contributions of the Association of Insolvency and Restructuring Advisors (AIRA) and all of you to promoting the national economy by helping businesses reorganize inside and outside of the bankruptcy system. You possess important skills that have a positive impact on our fellow citizens who rely upon an expanding economy where businesses can flourish and companies in financial distress may be rehabilitated or their assets deployed to more efficient uses. Your work saves and creates new jobs, and it fosters economic prosperity.

The great economist Joseph Schumpeter wrote about the importance of economic dynamism and the entrepreneurial spirit. He knew the personal sting of bankruptcy, but remained convinced that change and the "wild spirits" of entrepreneurs were the key to economic growth. An effective bankruptcy system is an essential element of every developed national economy. It encourages entrepreneurship by accounting for failure. Bankruptcy provides individual debtors with a "fresh start" and business debtors with a "breathing spell" during which the business can be reorganized or sold. Importantly, bankruptcy also provides a mechanism for the efficient distribution of assets in the event of business failure.

Role of the United States Trustee in Chapter 11 Cases

The role of the United States Trustee Program is to act as the "watchdog" of the bankruptcy system. Our mission is to promote the integrity and efficiency of the bankruptcy system for the benefit of all stakeholders. To accomplish this, we carry out a wide variety of administrative, regulatory, and enforcement responsibilities. Regardless of whether a case is consumer or business, liquidation or reorganization, our core responsibility is to help ensure that all participants in the bankruptcy system – consumers, business executives, creditors, and professionals – comply with the Bankruptcy Code.

The Limits of Discretion in a Code-Based Bankruptcy System

In the Bankruptcy Code, Congress established the rules and the public policies that bind all participants in the system. Neither judges exercising their discretion, nor the parties in a case reaching an agreement, can contravene the law or substitute their preferences for those of the Congress as expressed in statute.

1 Director White was unable to travel to Dallas, so these remarks were delivered on his behalf by William T. Neary, United States Trustee for Region 6 (the Northern and Eastern Districts of Texas). An abridged version of these remarks also was published in the July 2017 issue of *American Bankruptcy Institute Journal*.

One of the best examples of the limits of this arose in *Czyzewski v. Jevic Holding Corporation*, which was decided in March of this year by the United States Supreme Court. The essential facts in the case were that the debtor laid off employees on the eve of bankruptcy and later sought approval of a settlement to dismiss the case that provided for a final distribution of available assets. The problem was that the distribution excluded the WARN Act claims of the laid-off truck drivers, even though those claims were entitled to payment priority under the Bankruptcy Code. The proposed settlement favored lower priority creditors who would be paid in return for the creditors' committee's dropping a fraudulent conveyance lawsuit against the creditors who bought the company in a leveraged buy-out. Fortunately and appropriately, the Supreme Court said "no."

The USTP sided with the truck drivers in objecting to the settlement in bankruptcy court. We lost. We then unsuccessfully argued for reversal in the United States Court of Appeals for the Third Circuit. Ultimately, we were signatories on the Solicitor General's brief in the Supreme Court where we prevailed. The Supreme Court made clear that the bankruptcy court does not possess discretion to approve a final distribution through a structured dismissal that violates the priority of creditors carefully set forth by the Congress in the Bankruptcy Code – at least not without the affirmative consent of the harmed stakeholders.

The rationale of the *Jevic* decision may have major implications, not only in protecting the chapter 11 plan confirmation and priority of distribution process, but also in many other contexts where parties seek to circumvent statutory mandates.

Significant USTP Actions in Chapter 11 Cases

In carrying out our responsibilities, the USTP sometimes takes positions that are adverse to those of debtors and major creditors. This tension is consistent with the adversarial nature of any legal process and is particularly present in bankruptcy where there is a multiplicity of interests. To monied players in a case, bankruptcy is a framework for deal making driven by the motivation to obtain the best possible economic outcome. For the USTP, bankruptcy is a judicially supervised process that is not just guided, but defined, by a statute written by Congress. Our different perspectives are natural and contemplated by the Congressional draftsmen.

In our chapter 11 practice, the Program's responsibility to uphold the Bankruptcy Code is reflected in our day-to-day work of reviewing and, where necessary, objecting to proposed actions that we believe do not meet statutory standards. For example:

- We rigorously review applications to employ professionals to ensure the adequate disclosure of connections and the absence of disqualifying conflicts of interest. Over just the past year, we have been involved in numerous widely-reported cases in this regard. In one recent case, we objected to a large advisory firm's skeletal disclosures. Importantly, we worked out a reasonable scope of disclosure in light of the firm's exceptionally wide-ranging client base and expansive professional services in areas remote from the terms of the engagement in the extant case. The judge agreed with the USTP's position and the firm appears to have conformed subsequent applications to that position. In another case, the USTP objected to fees after it was revealed that there was a strong personal connection between principals in a law firm and the financial firm that was engaged to review the work performed by the law firm. Even though some expressed the view that the USTP should excuse the failure to disclose with minimal penalty, ultimately the court directed the disgorgement and denial of all fees.
- The United States Trustee is almost always alone in objecting to executive and insider bonuses that fail to meet the rigorous standards enacted by Congress in 2005 in section 503(c) of the Code. Over time, parties have become a bit more sophisticated in what can only be called evasion tactics. Instead of merely saying the money is required to retain insider executives, applicants dress up impermissible retention bonuses as incentive payments. We continue to see applications for bonuses that require unexceptional efforts by insiders, such as realizing a sales price which already has been offered by a stalking horse bidder. We also see motions seeking to assume pre-petition employment agreements that contain buried retention bonus provisions, even though section 503(c) clearly applies to agreements made pre-petition. Although in most cases we succeed in obtaining at least a modification of the initial bonus plan, it is disappointing that we have not succeeded more in improving compliance with the bonus restrictions that Congress has imposed.
- Similarly, the USTP is often the lone voice objecting to nonconsensual, non-debtor third party releases. Here is a common scenario: the debtor and large creditors who seek to control the post-confirmation entity place a provision in the plan releasing non-bankruptcy claims of non-debtors against other non-debtors without the consent of the releasing parties. They say key parties will withdraw from the deal without a release. It is important to note that a creditor's vote in favor of the plan does not in and of itself constitute consent to the release of that creditor's right to sue on its non-bankruptcy claims against non-debtors. And even in Circuits that are more lenient in approving non-debtor releases, the scope of proposed releases is often beyond the pale. We object, but seldom do other parties. The proponent's justification often boils down to two arguments having little to do with the merits: (1) the USTP has no financial interest in the case, so our objection should be disregarded; and (2)

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without the agreement, the whole deal will fall part. The court, understandably trying to bring the case to a conclusion, sometimes expresses skepticism about the objection as well. Lost in the argument, though, are the facts that: (1) the USTP was created as a neutral watchdog precisely so it would have the freedom to enforce the law as Congress has written it and to protect the rights of small creditors who cannot afford to participate actively in the case; and (2) often there is scant evidence that the benefitting parties will withdraw from the deal underlying the plan absent the releases. Not to make too fine a point, but frankly it seems that the proliferation of impermissible third party releases is due to one major factor – parties think they can get away with them. More often than not, we prevail, at a minimum, in obtaining substantial modifications to the proposed terms of the releases. But there is little doubt that, in many cases, the rights of non-consenting creditors would be unprotected but for the watchful eye of the USTP.

New Initiatives

Instead of describing numerous other issues that often cause us to object in a chapter 11 case, let me move on to describe two initiatives underway that may be of special interest to this gathering of insolvency and restructuring professionals. They relate to professional fees and employment terms for Chief Restructuring Officers. We will need your input on both. You are experts and we cannot possibly devise a workable framework without hearing from you individually and as an organization. We look forward to working with you on these in the months ahead.

Professional Fees of Financial Advisors and Investment Bankers

In 2013, the USTP issued new Guidelines for Attorney Fees in Large Chapter 11 Cases. We are now hard at work considering guidelines pertaining to financial advisors and investment bankers.

<u>Large Case Attorney Fee Guidelines</u>

The 2013 large case attorney fee Guidelines focused in significant part on seeking disclosures that would enable the court, United States Trustees, and parties to evaluate whether the law firm satisfied its burden to justify fees under statutory standards. Among other things, we focused on ensuring that fees reflected market rates rather than impermissible bankruptcy premium rates; that professionals submitted budgets to foster better cost controls; and that debtors considered cost-saving efforts, such as hiring lower-cost efficiency counsel to perform claims review and other "commoditized" tasks. We also urged that, in appropriate cases, courts approve the retention of experienced practitioners to serve as independent fee examiners to review the reasonableness of the fees in light of the work necessary to be performed in a case.

The Guidelines do not have the force of law. They are instructions to our own lawyers about the information they should receive from applicants in deciding whether to object to fee applications. Although some courts have adopted the Guidelines as a Local Rule to simplify enforcement, most courts have not done so. That creates some inefficiency because we sometimes have to negotiate the disclosures before we can analyze the information and determine if the fees should be awarded under statutory criteria.

After four years, we have concluded that the large case attorney fee Guidelines are achieving their purpose. We are obtaining better disclosures, firms are submitting budgets, and firms have improved their internal billing practices. We still occasionally see evidence of rates that are not adequately justified and of other non-compliant practices that we seek to remedy; but now, we and other parties have more complete information and transparency to decide whether to object to fee applications. And, in an example of the "dog that didn't bark," we note a substantial diminution in concerns about the practicality of the Guidelines initially expressed by applicant law firms.

<u>Fee Guidelines for Financial Advisors and Investment Bankers</u>

Using the same process that we used in developing the large case attorney fee Guidelines, we now are tackling large case fees for financial advisors and investment bankers. The process generally will entail outreach to stakeholders, publication of draft guidelines, a public meeting at which stakeholders can make statements and answer questions from USTP representatives, and publication of the final guidelines. This process not only provides the USTP with valuable insights and information from experts on the front end, but also transparency on the back end so all can see the enforcement criteria the Program will employ in deciding whether to object to the fees of financial professionals.

This is a fitting time to develop these guidelines. The fees charged by financial advisors in bankruptcy cases today sometimes exceed legal fees, and the scope of services goes far beyond the accountancy that used to be the main service provided. Both financial advisors and investment bankers are essential actors in analyzing the core financial problems of the debtor's business, valuing assets, devising strategies for reorganization or sale, and identifying investors and buyers. Nonetheless, standardized disclosures of services and time spent often are vague and insufficient. In the case of investment bankers especially, there need to be more meaningful disclosures of services and metrics for evaluating success.

More frequently for financial professionals than attorneys, retention agreements provide for a fee arrangement under section 328 of the Code. Instead of using the section 330 lodestar approach of average hourly rate times reasonable time spent delivering agreed-upon services, a basic sum is agreed to at the beginning of a case. Although the

USTP agrees that alternative fee arrangements can provide a more efficient mechanism for charging for professional services than the lodestar, they certainly should not be used to evade basic disclosures required under the Bankruptcy Code and Bankruptcy Rule 2016.

Investment bankers, probably more than any other professionals, have used section 328 in their retention agreements. Under the so-called "Blackstone Protocol," USTP offices concur with the section 328 term with a proviso that fees at the end of the case still can be reviewed by the United States Trustee under the more expansive factors set forth in section 330. Some say that this defeats the purpose of having a pre-approved compensation term. We understand that point of view. But these retention applications often are submitted for approval while the proverbial "ice cube" is melting and efforts are intensely focused on trying to salvage the business or arrange a sale. As a result, the applications may lack the necessary evidentiary support and the parties and the court may not be in the best position to conduct the rigorous review required of the pre-approved compensation terms.

With new guidelines, we hope the courts and all parties will have more information so that fees can be awarded with greater assurance that they were earned under the reasonableness standards set forth in the Code.

Employment Terms for Chief Restructuring Officers

Another initiative directly affecting many members of this audience involves the retention of Chief Restructuring Officers (CROs). It is well established that the CRO industry has grown markedly in the bankruptcy world over the past two decades. Just as CROs play an integral role in turning around distressed enterprises outside of bankruptcy, increasingly they have navigated companies through the shoals of chapter 11 and helped manage corporate debtors back to financial health to the benefit of shareholders, creditors, and employees.

CROs Are Not a Substitute for a Chapter 11 Trustee

While CROs can play a constructive role, they cannot fill the shoes of a chapter 11 trustee when cause exists warranting the appointment of an independent fiduciary under section 1104. Sometimes businesses have engaged in pre- or post-petition activity that disqualifies current management and the board of directors from serving as the debtor-in-possession.

As all of us know, upon the filing of a bankruptcy petition, by operation of law, management transforms into a fiduciary that is bound to act for the benefit of all stakeholders, including creditors. A recent history of financial irregularities, egregious mismanagement, or indifference by the board, along with other facts, may render the company's management unfit for service as a fiduciary. In such circumstances, the Bankruptcy Code and principles of sound corporate governance dictate that the court authorize the United States Trustee to appoint an independent chapter 11 trustee. Unsurprisingly, management usually resists, and it is often joined in opposition to the United States Trustee's motion for a trustee by controlling creditors or the official committee.

Sometimes management seeks to defeat a trustee by appointing a CRO who reports to the same board that failed to detect or remedy prior management's malfeasance or nonfeasance. We hear predictable arguments that continuity is needed, a trustee will result in additional costs to the estate and a delay in the ultimate resolution of the case, creditors will not contribute funds to a plan with unknown trustee management, or some other argument designed to thwart a trustee. As much as we may respect the integrity and qualifications of a particular CRO, we do not accept those arguments.

There are numerous cases in which the selection of a CRO by the culpable corporation has simply preserved management's prerogatives and led to no benefit to the estate. And the lack of independence in and of itself diminishes the integrity of the process, despite the highest integrity of the individual CRO. In our view, too few chapter 11 trustees are appointed in the modern bankruptcy system. In many districts, case law sets the burden of proof at the heightened "clear and convincing" evidence standard, rather than the typical "preponderance" of the evidence standard. The fact is that it is easier to deny a discharge to a consumer debtor – known as the death penalty of bankruptcy – than it is to obtain an order ousting incumbent management in favor of an independent chapter11 trustee. That is both unfair and contrary to the statute.

As much as we appreciate the role CROs should play in the bankruptcy system, we will persist in our position that, if grounds exist to appoint a trustee, the appointment of a CRO does not provide a substitute cure. Of course, sometimes we appoint a member of the CRO community as the trustee. When we do that, the CRO not only offers his or her deep expertise, but does so free from tainted management's control and influence.

USTP Protocol on Scope of CRO Retention

In recognition of the important role CROs can play in many bankruptcy reorganizations, almost 20 years ago we developed a protocol governing USTP consideration of the scope of a CRO engagement. Because a CRO who worked for the company prior to filing would be disqualified under the employment provisions of section 327 of the Code, we studied the matter and developed what became known as the "J. Alix Protocol." Under that Protocol, we state publicly that we will not object to employment of a CRO if the debtor applies for retention under section 363 pertaining to the use of estate funds out of the ordinary course of business and also agrees to other protections against conflicts that would apply to a professional employment application under section 327. For many years, this solution has properly harmonized the demands of the Bankruptcy Code with the debtor's practical need for CRO services.

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Over the two decades since the Protocol was adopted, however, there have been many changes in the CRO industry. Both the frequency of employment of CROs and the scope of services offered by CRO firms have grown dramatically. We have reached out to participants in the restructuring business and other stakeholders for information on how the Protocol should be updated to account for the facts of modern practice, while remaining faithful to the conflict of interest provisions of the Code. Among the issues to be considered are: whether the "one hat" rule limiting the CRO to a single role as either manager or financial advisor can be made more flexible; whether there should be a reduction in the post-engagement period of time during which the CRO or members of the CRO firm are prohibited from investing in the securities of the reorganized company; and whether the indemnification of the CRO should be aligned with the indemnification of officers outside of bankruptcy.

After completing our initial outreach, we plan to follow generally the same process we used for the large case attorney fee Guidelines. To ensure transparency, we will publish proposed revisions, seek public comment, hold a public meeting, and issue final guidelines that will ensure the consistent treatment of CRO applications by all USTP offices around the country.

Conclusion

I thank you for your time today. Over the next three days, you will hear from interesting speakers and address topics that I am certain will provide a professionally enriching experience. But in all of the material and discussion, there is one most important fact to keep in mind: the work you do can help the broader American public. You have a duty to your client, but by faithfully discharging that obligation, you are creating a more prosperous economy that should help Main Street businesses and average consumers who head off to work every day.

As Professor Schumpeter said, "economic progress, in capitalist society, means turmoil." And bankruptcy surely displays a good bit of turmoil. But insolvency and restructuring advisors are there to help manage that turmoil. And the USTP is there to help ensure that the reorganization process goes forward in accord with the rule of law as written by the Congress. If we all do our jobs, then the result at least will reflect the democratic process and hopefully result in economic growth and prosperity that benefits all of our fellow citizens.

Thank you for what you do. I look forward to working with you, and negotiating with you. And, as a last, but sometimes necessary, resort, I look forward to seeing you in court.

My respect and best wishes to each of you.

ABOUT THE AUTHOR

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Cliff White is the Director of the Executive Office for United States Trustees, United States Department of Justice. He is a career civil servant and the longest serving Director of the United States Trustee Program (USTP). After serving as Acting Director from May 2005, he was appointed as Director in 2006. During his 35 years of public service, Cliff has served as Deputy Director of the USTP, an Assistant United States Trustee, a Deputy Assistant Attorney General, and in other positions.

Bankruptcy Taxes

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The Impact of Cancellation of Debt Income in Debt Restructurings

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In debt restructurings the majority of the focus tends to be on how lenders can cooperate with borrowers to reduce their debt, modify their debt instruments and in some cases even cancel their indebtedness altogether. For borrowers, debt restructurings represent a second chance, while lenders improve their odds of receiving at least some repayment on loans.

However, a reduction, modification or cancellation of indebtedness can have significant consequences under federal tax law and too often owners of debt, borrowers, and guarantors fail to take tax considerations into account when they restructure debt instruments.

This article is intended to provide a high level overview of certain tax rules that apply when debt instruments are forgiven, modified, transferred or otherwise satisfied for less than the total amount of the debt as part of a debt restructuring.

What is Cancellation of Debt Income?

Normally when funds are borrowed the loan proceeds are not required to be included in income because there is an obligation to repay the lender.

However, Internal Revenue Code ("IRC") Section 61(a)(12) states that gross income includes income from the discharge of indebtedness. If a loan obligation is forgiven, whether partially or in full, the amount of loan forgiveness is required to be reported as income since there is no longer an obligation to repay the lender. In such circumstance, the resulting income is generally referred to as Cancellation of Indebtedness Income ("CODI").[1] However, CODI can also be triggered by various other actions.

Changes to the Terms of a Debt Instrument

If the terms of a debt instrument are changed "substantially" the modified debt instrument may be treated as a new and separate debt instrument issued in full satisfaction of the old debt. As a result of such deemed exchange, the debtor may have CODI.[2]

Debtor's Acquisition of Own Debt

If a debtor buys back its own debt from a third-party creditor for an amount that is less than the amount of the debt, then CODI may be triggered, even though the creditor has not formally cancelled the debt. The rationale for the inclusion is that the creditor has transferred the debt back to the debtor for only a partial payment of the amount due.

Acquisition of Debt by Party Related to Debtor

Similarly, the acquisition of debt at a discount from an unrelated creditor by a party that is related to the debtor can trigger CODI to the debtor.[3] The rationale for the inclusion is that if the relationship between the purchaser of the debt and the debtor is sufficiently close, then the transaction should be viewed no differently than if the debtor purchased its debt directly.

Determining whether a party is related for this purpose in itself is complex, but two entities generally will be treated as related if one owns more than 50% of the other, or if indirect common ownership of the two entities is greater than 50%.[4] Additionally, certain family members are treated as related and this treatment may cause otherwise unrelated entities to be treated as related.[5]

Does the Type of Debt Make a Difference?

Many debt restructurings do not involve simple cancellation of debt, as a creditor may agree to accept collateral

1 Based on prior court cases and IRS Memos, the IRS generally has recognized that a guarantor (whether or not the primary obligor has defaulted and the guarantor has become liable for the indebtedness) does not realize CODI upon release of a liability. IRC Section 108(e)(2). See also, IRS Memo 61.09-18. INFO 2002-0024. Landreth v. Commissioner, 50 T.C. 803 (1968).
2 Treas. Reg. §§ 1.1001-1(a), 1.1001-3(b)
3 IRC Section 108(e)(4).
4 IRC Section 108(e)(4)(C).
5 IRC Section 108(e)(4)(B).

in complete satisfaction of the debt (e.g., foreclosure, repossession, abandonment, etc.). Such actions amount, for tax purposes, to a sale of the property; and, as such, the debtor may have some mix of CODI and taxable gain or loss depending on whether the debt is recourse or nonrecourse.

Recourse Debt

A recourse debt allows a creditor to recover other debtor assets in addition to the original collateral. The acceptance of the collateral is split between CODI and taxable gain. The transaction will result in a taxable gain or loss on the difference between the fair market value of the property and the debtor's basis. If the fair market value of the property exceeds the debt, there is no CODI. If, however, the fair market value of the property is less than the debt, the debtor may realize CODI, to the extent that the cancelled debt exceeds the fair market value of the property, in addition to any taxable gain or loss.

Nonrecourse Debt

Nonrecourse debt bars a creditor from attaching assets of a debtor beyond the original collateral so there can be no CODI. As with recourse debt, a voluntary conveyance or foreclosure in satisfaction of the debt is treated as a sale or exchange of the transferred property. The debtor realizes a taxable gain or loss equal to the difference between the principal amount of the debt and the basis of the property.

Is There Relief From CODI?

As discussed above, while a wide variety of actions can trigger CODI, fortunately for many taxpayers, IRC Section 108 provides certain exceptions which may be available to eliminate the recognition of CODI.

However, in many cases certain adjustments are required that could affect future taxation (as discussed further below).

The exceptions to recognition of CODI include the following:[6]

- Title 11 Bankruptcy
- Insolvency (discussed further below)
- Qualified Farm Indebtedness
- Qualified Real Property Business Indebtedness)
- Qualified Principal Residence Indebtedness

6 IRC Section 108(a)(1). A discharge, which occurs in a Title 11 case, takes precedence over all other exclusions from gross income and the insolvency exclusion takes precedence over qualified farm exclusion and qualified real property business exclusion under IRC Section 108(a)(2).

Insolvency Exception - Effect on Partnerships and S Corporations

Generally, insolvency is the amount that a taxpayer's liabilities exceed the fair market value of a taxpayer's assets. For this purpose, fair market value is the price at which property would change hands between a willing buyer and a willing seller, both being informed of the relevant facts and neither being compelled to buy or sell. Liabilities are generally determined using the principles of the accrual method of accounting. Contingent liabilities may be included depending on the likeliness of the fact of the liability to occur. A taxpayer's insolvency is determined immediately before the debt is discharged.

Normally for a C corporation, insolvency (as well as bankruptcy) is determined at the corporate entity level. However, many private equity ("PE") and venture capitalist ("VC") funds, as well as private businesses, are often structured as pass-through entities (e.g., limited liability companies taxed as partnerships ("LLCs"), partnerships, and S Corporations), which have different insolvency testing requirements from that of a C corporation.

LLCs and Partnerships

For companies that are structured as an LLC taxed as a partnership or a partnership, the tests for the insolvency and bankruptcy exception is determined at the partner/member level, not at the entity level.[7] This requirement can often make it very difficult for partner/member investors to claim the insolvency exception because although the operating entity investment may be insolvent, the partner/member investors are not likely to be insolvent.

S Corporations

Many businesses which are owned by individual shareholders and certain trusts are owned through S corporations. The insolvency exceptions apply at the entity level.[8] If the S corporation qualifies for the insolvency exception, only the balance of the CODI not excluded by the corporation is passed through to the shareholders.

Is There a Cost for Relief from CODI?

While bankrupt and insolvent taxpayers can exclude CODI from taxable income such exclusions will reduce certain tax attributes to the extent possible. The following tax attributes are reduced in CODI situations generally in the following order:[9]

- Net operating losses or the carryover of disallowed S corporation losses or deductions
- General business credits
- Minimum tax credits
- Capital loss carryovers

7 IRC 108(d)(6).
8 IRC 108(d)(7).
9 IRC Section (b)(2). Note S corporation attribute reduction is applied at the S corporation level with the exception of reduction of the carryover of losses and deductions disallowed under IRC Section 1366(d)(1) which is applied at the shareholder level under IRC Section 108(d)(7)(B).

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- Tax Basis of the property
- Passive Activity Loss & Credit carryovers
- Foreign Tax Credit carryovers

The reduction in basis because of CODI in bankruptcy or in insolvency cannot be more than the total basis of property held immediately after the debt cancellation, minus the total liabilities immediately after the cancellation. However, this limit does not apply if an election is made to reduce the basis of depreciable property before reducing other attributes. [10]

Elections for Inventory and Depreciable Property

A company with CODI may elect to reduce the basis of depreciable property before reducing any other tax attributes. However, this reduction of the basis of depreciable property cannot be more than the total basis of depreciable property held at the beginning of the tax year following the tax year of the debt cancellation.[11]

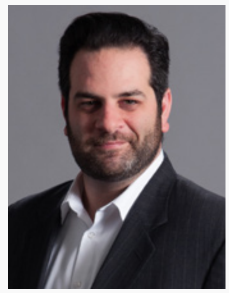
Additionally, in the case of real estate companies, a company may elect to treat all real property held for sale to customers in the ordinary course of a trade or business, as if it were depreciable property.[12]

A company makes the election to reduce the basis of depreciable property before reducing other tax attributes as well as the election to treat real property inventory as depreciable property, on Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment).

Conclusion

Given the complexity and material consequences of these CODI rules, taxpayers should understand and consider them as an important part of the debt restructuring process.

ABOUT THE AUTHOR



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10 IRC Section 1017(b).
11 IRC Section 108(b)(5).
12 Treas. Reg. § 1.1017-1(f).

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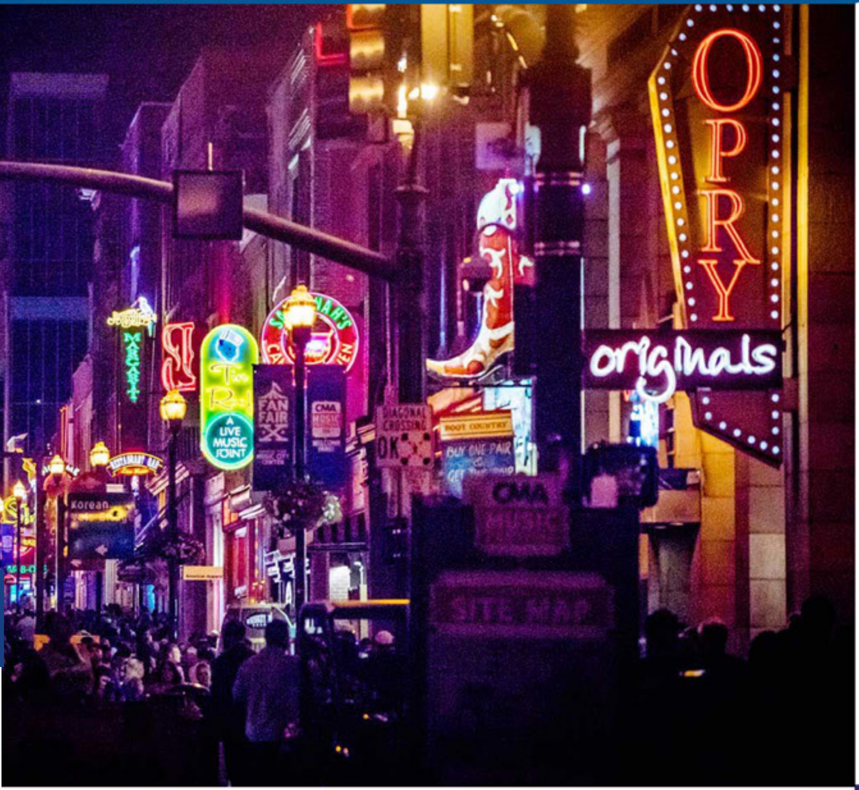

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Broadcast Radio Can Still Go Digital, but the Clock Is Ticking

CHRIS BLACKER, DARIN FACER, KENT PERCY, AND STEVE SPITZER, *AlixPartners, LLP*

Broadcast radio was one of the hardest-hit industries during the 2008 financial crisis. Advertisers, radio's primary source of revenue, pulled back, causing the industry's revenue to drop from a high of $19.5 billion in 2008 to $16.0 billion in 2009—a staggering, 18% year-over-year decline.

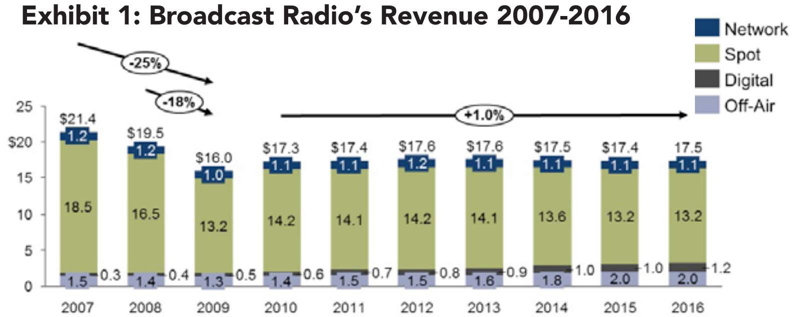
In the past few years, revenue partially recovered and now remains steady at about $17 billion.[1] But the average time consumers spend listening to broadcast radio each week seems to have permanently shrunk by 3.1 hours per week from 2010 to Q3 2016.[2] At the same time, digital radio has thrived. Revenue jumped from $615 million in 2010 to $1.0 billion in 2015—an increase of 66%—and weekly time spent listening to digital format radio increased by 3.9 hours.[3]

To capitalize on the growth of digital radio, broadcasters should look to diversify and move more of their business into this space. However, to diversify successfully, broadcasters will have to overcome two significant obstacles: a market dominated by a handful of digital radio players and prohibitive copyright fees. We'll first discuss how broadcasters should approach copyright fees, and then we'll offer some recommendations on how they can build a stronger digital presence.

Traditional Broadcast Radio Is Stalling

After suffering from dramatic revenue declines during the 2008 financial crisis, broadcast radio partially recovered from 2009 to 2010. But since 2010, overall revenue has been stagnant, increasing by only 1.0% from 2010 through 2016 (Exhibit 1).

Exhibit 1: Broadcast Radio's Revenue 2007-2016



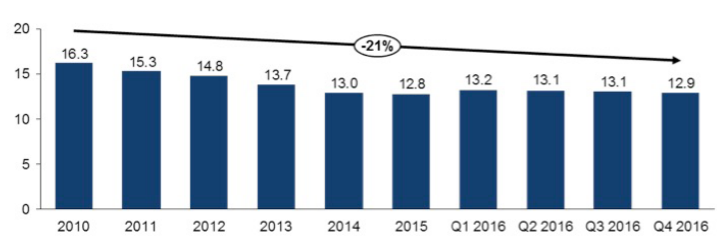
Source: Miller Kaplan Arase, LLP, Standard Media Index, AlixPartners

If we exclude digital revenue—meaning, revenue generated from broadcast radio stations' web sites and applications—and off-air revenue—meaning, revenue generated from live events hosted by radio stations—the picture grows much more dramatic.

From a low in 2009, spot revenue[4]—which represents approximately 76% of total revenue—and network revenue recovered slightly from their 19% decline from 2008 to 2009, only to show signs of softening again in recent years.[5]

Today all broadcasters face two significant revenue challenges: generating sustainable revenue from their advertising base and maintaining total listener volume. Industry-wide, the average weekly time spent listening dropped 21% from 2010 to Q4 of 2016 (Exhibit 2).

Exhibit 2: Broadcast radio stations: Weekly time spent listening (hours)



Source: RADAR (2010 – 2016), Nielsen Total Audience report, AlixPartners

1 Miller Kaplan Arase, LLP, Standard Media Index, AlixPartners.

2 RADAR (2007–2016), Nielsen Total Audience Report, AlixPartners.

3 Miller Kaplan Arase, LLP, Standard Media Index, RADAR (2007–2016), Nielsen Total Audience Report, AlixPartners.

4 Revenue from advertising that can only be seen in a specific local area, as opposed to network-wide advertising.

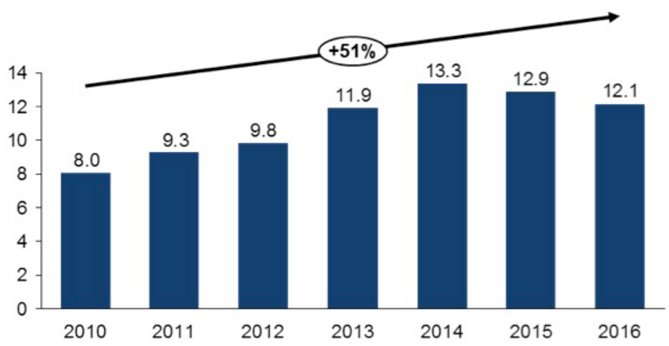
5 Miller Kaplan Arase, LLP, Standard Media Index, RADAR (2007–2016), Nielsen Total Audience Report, AlixPartners.

The total decline in listening hours from 2010 to mid-2016 is considerable. Furthermore, during the same period, many listeners migrated away from traditional broadcast radio and toward digital radio offerings, broadcasters' online stations, and internet-only radio channels.

Digital Radio: A Light at the End of the Tunnel

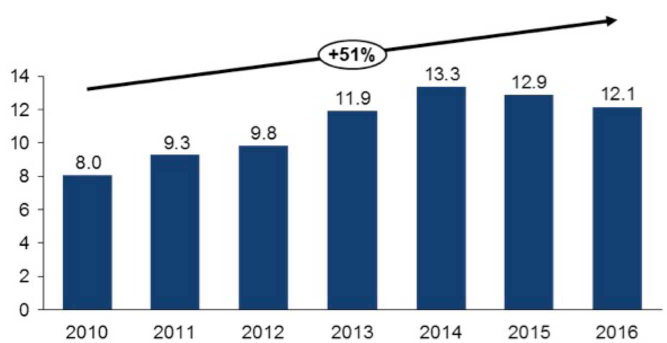
For broadcasters, a light at the end of the tunnel has been the digital format. During the same period that spot and network revenue was sluggish, the radio industry increased its digital revenue significantly (Exhibit 3). Since 2010, time spent listening to digital radio has increased by 51% (Exhibit 4).[6]

Exhibit 3: Digital revenue from traditional broadcast radio stations ($ in billions)



Source: Miller Kaplan Arase, LLP

Exhibit 4: Digital radio - Weekly time spent listening (hours)



Source: RADAR (2010-2016), Nielsen Total Audience Report, AlixPartners

The quick rise of digital radio—including both broadcasters' online platforms and pure-play digital radio properties like Pandora—has come largely from the rapid increase in smartphone ownership during the same period.[7]

Although digital revenue from broadcast radio stations has increased at a healthy rate in the past few years, many broadcasters still have no significant digital presence. Based on our estimates, the average radio station's digital revenue is only 5 to 8% of total revenue.[8]

Currently, the digital radio industry is dominated by only a handful of players. Pandora, broadcast radio's direct competitor, leads the online radio industry by commanding a huge, 81% of market share for radio listening hours. Meanwhile, iHeartMedia, a traditional broadcast company that owns 850 broadcast radio stations throughout the United States, has 7.8% of market share. CBS Radio, a traditional broadcast company that was recently sold to Entercom Communications, owns and operates 117 radio stations, has 3.4% of market share. Together those companies make up 92.2% of online radio listening.[9] The other 7.8% is made up of other broadcasters that have an online presence or Internet-only radio stations.[10] And broadcasters may find it challenging to take market share away from the dominant players.

The next section explores the main reason many broadcasters have had trouble building a significant digital presence.

The Innovator's Dilemma

One of the major reasons so many broadcast radio stations have not developed a robust online presence is that sound recording royalty fees are extremely expensive. Under current US copyright law, songs have two types of copyrights: one related to musical composition and one related to sound recording. Musical composition copyrights are typically held by songwriters and music publishers, and sound recording copyrights are typically held by recording artists and record labels.

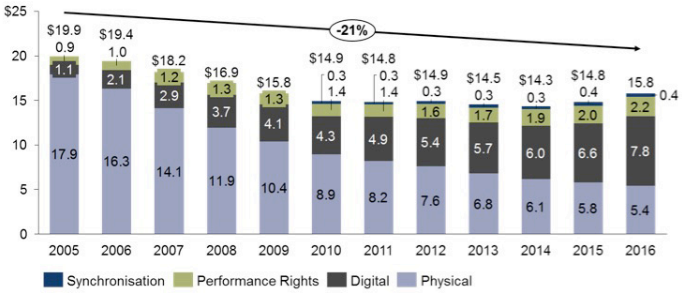
Today's mainstream broadcasters that play songs over the air have to pay royalties to musical composition copyright holders but not sound recording royalties. Broadcast radio stations have so far successfully argued that they should not have to pay sound recording royalties because songs played over the air provide free promotion for recording artists, which leads to increases in music sales, thereby ultimately benefiting both the recording artists and related record labels. The musical composition royalty is typically about 2 to 5% of a radio station's gross revenue.[11]

However, as a result of the 1998 Digital Millennium Copyright Act (DMCA), broadcasters that stream songs online have to pay both musical composition and sound recording royalties. The DMCA was meant to protect the recording industry from music piracy during the rise of the Internet in the early 1990s. Record artists and record labels have fought that inconsistency for years and battled with broadcast radio stations to make them pay sound recording royalties for songs played over the air. Tensions have only intensified in recent years as global recorded music revenue declined dramatically because of the prevalence of piracy and file-sharing Web sites (exhibit 5 on next page).

6 The Infinite Dial 2016.
7 The Infinite Dial, "The Little Machines That Built Pandora," April 9, 2015.
8 AlixPartners analysis.
9 IBISWorld Internet Radio Broadcasting in the US, June 2016.
10 Note that Apple Music and Spotify are not defined as digital radio because their platforms are content on demand.
11 John Villasenor, "Pandora's Box: New Legislation Might Finally Fix the Messy Internet Radio Royalty System," Slate, September 24, 2012.

Continued from p.23

Exhibit 5: Global recorded music industry revenues 2005 – 2016 ($ in billions)



Synchronization revenue is income from the use of music in TV advertisements, films, and brand partnerships. Performance rights revenue is related to royalties from musical composition and sound recording.

To get a sense of how expensive sound recording royalty rates can be for broadcasters with a digital presence, we attempted to assess financial information that delineated broadcasters' traditional side of the business and their digital side of the business. Unfortunately, we were unable to find data that provided only a breakdown of the digital business. Instead, we examined broadcast radio stations' largest online competitor, Pandora. In 2015, Pandora had at least 250 million registered users streaming a total of 21.11 billion hours. Pandora paid $0.14 per 100 songs streamed that year. Although the company generated $1.16 billion in revenue, 46% of that revenue went to pay sound recording royalties.[12] Clearly, royalties can eat up a huge chunk of revenue.

Getting on the Same Wavelength

Despite such daunting costs, broadcasters should persist in building their digital presence; otherwise, they risk losing relevance in today's marketplace. One of the strategies they can use involves making the most out of their existing relationships with artists and record labels: working hand in hand to manage the high cost of royalty fees.

This calls for some creativity. For instance, a broadcaster might offer to pay a percentage of broadcast revenue as sound recording royalty to the artists and record labels and negotiate a lower sound recording royalty rate on the digital side. This would serve dual purposes: it would continue to develop and manage the cost to the digital side of the business, and it would serve as insurance in the event that legislation ever changes to force broadcasters to pay sound recording royalty rates.

One company we've seen taking a step in this direction is iHeartMedia. Through the years, iHeartMedia has worked with many record labels—currently 28, with Warner Music Group the largest among them[13]—and has negotiated a royalty scheme for both its broadcast and digital radio businesses whereby artists and record labels receive increases in sound recording royalty revenues from the company. (Specific numbers are not available because the terms of the partnerships have not been disclosed.) In exchange, the company has the rights to manage and stabilize the cost of its digital business.

As of May 2016, iHeartRadio had more than 100 million registered users and 85 million followers across its social network.[14] In addition, the company has partnered with a number of radio stations such as Univision, as well as public radio stations such as WNYC to make these radio stations accessible on its iHeartRadio application. As a result, even though iHeartMedia owns only 850 radio stations, more than 2,000 radio stations are accessible through the iHeartRadio application.[15]

Broadcast radio stations that have not developed an online presence should execute a similar strategy by partnering with a company that has a significant online presence. Alternatively, they can form strategic alliances between themselves to negotiate with artists and record labels, thereby expanding the size of the pie for both industries.

How to Go Digital: The Playlist

The radio industry is in the midst of a radical transformation, with digital delivery changing how content reaches listeners. Currently, a handful of companies dominate the digital radio industry, but maintaining that dominance is not a fait accompli. Broadcast radio stations that have not developed a strong digital presence still have time to accelerate their own growth, however the runway is shortening. Following are three recommendations to get started.

- **Extract cash from existing operations to reinvest in digital platforms.** Even though traditional stations' revenues have declined, stations have been slow to cut costs. As a result, gross margin has declined at a faster rate than revenue, which has driven a steep decline in net income.[16] Stations can get ahead of the cost curve and generate long-term cash flow for reinvestment in digital platforms and alternative media. They should closely examine programming, engineering, and news as areas for cost reduction, because managerial relationships remain high. In addition, although stations have streamlined their general and administrative costs in the past few years in order to bring down expenses, they should consider other options to further reduce their burdens—for instance, outsourcing or creating centers of excellence or establishing administrative offices in more-cost-effective locations. Stations that exploit such opportunities can extend their shortening runway. If they need a fresh perspective, they can bring in outside support to jump-start the initiatives.
- **Invest in both a digital team *and* an analytics team.** Understanding and utilizing big data is important. Stations that want to invest in digital should develop the capabilities to collect and analyze data generated

12 Pandora 2015 Annual Report.
13 Fischel & Lichtman Exhibit C and iHeartMedia Copyright Royalty Board testimony.
14 iHeartRadio Web site August 2017.
15 Radio's Most Innovative.
16 S&P Capital IQ.

by this activity. The online, on-demand culture has bred increasingly sophisticated consumers and advertisers that want services tailored specifically to their individual needs. Pandora, for example, has done an excellent job of using its data to help advertisers understand the company's value. The company collects more than one billion data points every day from its 80 million listeners.[17] Using its proprietary algorithms, the company can target listeners with advertising customized to those listeners' interests, which is more effective. The next phase in the radio industry's evolution will be an arms race to gather data and use analytics to deliver content that is closely tailored to users and advertisers. Stations without these capabilities will have to either develop them internally or seek outside support from third-party experts.

- **Develop a digital business plan.** Broadcasters transitioning to online content models cannot simply repackage their existing broadcast content and move it to the digital sphere. They must develop new business models because these days, online consumers and advertisers approach web platforms with higher expectations. Consumers look for digital content that will provide both a *lean-back* experience, wherein they receive content chosen by the broadcaster, and a *lean-forward* experience, wherein they select the songs they want to hear. Online advertisers prefer a high-quality customer experience with minimally invasive advertisements (e.g., banner ads) that target specific demographics. This means traditional radio companies should develop different approaches to advertising—ones that do not paint all listeners with one broad brush.

Time to Tune In to Digital

How consumers access music, news, and other audio content has changed dramatically in just a few years, and broadcast radio is feeling the heat. Trimming general and administrative costs may have been helpful in the past, but in today's environment, those measures may not go far enough to help a broadcaster get ahead of the competition. Instead, broadcasters should embrace the meteoric rise of the digital radio industry. They cannot afford to allow a mere handful of rivals to dominate this growing market.

Fortunately, it's not too late to get involved. The broadcaster that takes aggressive steps now to grow its digital presence and negotiate more-palatable royalty fees will put itself into a stronger position as consumer preferences shift and a new era of digital radio takes hold.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of AlixPartners, LLP, its affiliates, or any of its or their respective other professionals or clients.

17 2016 hivio conference.

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